

**INTERNATIONALIZATION**  
*of the Securities Markets*

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***CHAPTER V***

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**International Trading and Global  
Securities Markets**

**Prepared by the Division of Market Regulation**

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## CHAPTER V

### INTERNATIONAL TRADING AND GLOBAL SECURITIES MARKETS

#### A. Introduction

This chapter discusses the internationalization of secondary securities markets 1/ from several perspectives. It begins with an overview of some of the major segments of these markets: the Eurobond markets, the leading example of an integrated multinational secondary market; international equity markets, and particularly the developing foreign securities markets in London; and the international operations of multinational securities firms. The chapter then describes the staff's policy concerning two major areas of regulatory concern, broker-dealer registration and financial responsibility.

The Commission and its staff, through the Global Trading Release, 2/ the work on this study, and the February 17, 1987, Internationalization Roundtable, 3/ have monitored developments in the international secondary markets. To date, this process indicates that the markets are evolving trading and information gathering mechanisms that, in general, are safe and efficient. There is, however, a demand for improvements in international

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1/ The term "secondary securities markets" generally refers to the markets for trading securities after their initial issuance.

2/ Securities Exchange Act Release No. 21958 (April 18, 1985), 50 FR 16302. A summary of the comments on this release is attached as Appendix A.

3/ A summary of the Roundtable is attached as Appendix B.

clearance and settlement mechanisms. Accordingly, the staff has adopted a regulatory approach that facilitates industry solutions while ensuring the essential soundness and integrity of the U.S. national clearance and settlement system. The international clearance and settlement linkages established by the self-regulatory organizations ("SROs") and approved by the Commission are described in this part.

The SROs and the Commission also have devoted substantial efforts to facilitate the development of trading linkages. In this connection, the Commission has indicated that effective intermarket surveillance is essential to the integrity of internationalized secondary markets. 4/ The Commission has approved several linkage agreements that provide for such surveillance and enforcement cooperation. These agreements are described in this part of the study. 5/ Finally, this chapter describes the way in which Rules 10b-6 and 10b-7 under the Securities Exchange Act 6/ affect secondary market trading activity during international offerings.

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4/ See, e.g., Securities Exchange Act Release No. 22442 (September 20, 1985), 50 FR 39201.

5/ The Roundtable participants agreed that the Commission should continue to direct its principal focus to clearing and settlement and surveillance sharing agreements. See Summary, Appendix B.

6/ 17 C.F.R. 240.10b-6 and -7.

B. Barriers to Entry and the National Treatment Study

Because the recent National Treatment Study, prepared by the Treasury Department with the assistance of the Commission, covers the issue of barriers to entry of U.S. securities firms in different foreign markets comprehensively, this topic is not discussed separately in this study. The Treasury Study concluded that the major markets studied usually seek to accord national treatment to U.S. securities firms. Since the date of the Study, France has substantially liberalized entry of foreign firms into its markets. 7/ In addition, the Tokyo Stock Exchange is reviewing the possibility of increasing the number of seats allocated to foreign firms by May 1988. The Japanese government also is expected to grant licenses to several United Kingdom and foreign banks to conduct investment management activities in Japan. 8/

Some barriers remain, however, including restrictions on U.S. firms' access to foreign exchanges. Moreover, certain restrictions that apply equally to foreign and domestic firms

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7/ See, e.g., "France Proposes a Liberalization of Stock Market," Wall Street Journal, March 11, 1987, p.41; "Foreigners Will be Able to Own French Brokers," New York Times, March 11, 1987, p.D1.

8/ See "Japanese Likely to Grant Investment Licenses Soon," Financial Times, May 23, 1987, p.1, and "Tokyo Exchange Expects to Study Foreigners' Role," Wall Street Journal, May 19, 1987, p.46.

may uniquely disadvantage U.S. firms, such as restrictions on the development of new products. 9/ In addition, one new concern in this area arose when the Japanese Ministry of Finance ("MOF") determined to permit Japanese institutions to trade financial futures, but not options. The Commission has written the MOF suggesting that there is no regulatory or economic reason for this disparity of treatment. 10/ The MOF responded by indicating that they traditionally have distinguished futures from securities options and "could not include standardized options in the liberalization" at this time without further study. 11/

#### C. Eurobond Trading and Settlement

The term "international markets" encompasses two different types of markets: (1) the foreign securities segments of various national securities markets, i.e., the offering and

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9/ See Department of Treasury National Treatment Study, pp.4-5 (1986). Since this study there have been several legislative proposals in this area, including: (1) H.R. 3 and S. 1409, which, in pertinent parts (Sections 428 and 602, respectively) would prohibit a foreign firm from becoming a primary U.S. government securities dealer if the firm's home country does not accord U.S. firms equivalent competitive opportunities in the foreign country's government securities markets; and (2) S. 1420, which, in pertinent part (Section 1503) would allow the SEC, with the President's prior approval, to deny broker-dealer registration to any foreign firm whose home country does not accord to U.S. brokers and dealers "the same competitive opportunities as it accords to their domestic counterpart."

10/ See letter from John Shad, Chairman, SEC, to Makato Utsumi, Director-General, International Finance Bureau, MOF, dated April 30, 1987.

11/ See Letter from Makato Utsumi, Director-General, International Finance Bureau, MOF, to John Shad, Chairman, SEC, dated May 26, 1987.

trading of a security of an issuer of one country in the market of another country; and (2) integrated multinational markets. 12/ While the first markets are multinational in the sense that a particular security may trade in more than one country, trading occurs in discrete national markets linked only by whatever arbitrage may be possible. In integrated multinational markets, offering and trading occurs in one formally linked market setting. 13/ This section of the report describes the secondary Eurobond markets, 14/ a principal example of integrated

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12/ 1 International Finance Handbook (Wiley-Interscience, 1983), § 1.1, pp.1-7; § 5.1, p.3.

13/ Integration as used in this chapter means either: (1) trading occurs under one set of uniform procedures and under the umbrella of one SRO; or (2) traders are linked via formal data communications facilities. Eurobond markets are partially integrated in the former sense but not yet in the latter. Other multinational markets (e.g., the U.S./Canadian equity markets links) are integrated in the latter sense but not the former.

14/ While the Eurobond market sometimes is referred to as one market, dealers view each bond type -- e.g., floating-rate or fixed-rate U.S. dollar bonds -- as a separate market, and these separate markets evidence different liquidity. An illustration of such differences is provided by the perpetual floating-rate note market. Perpetual floating-rate notes are debt securities without a maturity date used by many commercial banks in Europe to raise permanent capital. Because these securities have no maturity date, their value is dependent to a large degree upon the presence of liquid secondary markets where holders can sell. In December 1986, due to decreasing fixed interest rates, the secondary markets for these floating-rate securities experienced severe disruptions and dealers in large part withdrew from these markets. See, e.g., "FRN Traders Struggle to Restore Stability," Financial Times, December 4, 1986, p.24. More recently, the slowdown of the fixed-rate Eurodollar bond offering market has led to decreased secondary market liquidity. The Euroyen bond on the other hand has experienced increased liquidity as the value of the yen has increased.

multinational secondary markets. The settlement mechanisms for these transactions in this market also are described.

1. Eurobond Trading

Secondary Eurobond markets are the major integrated multinational securities markets. In 1986, dollar volume in this market was over \$2.6 trillion. 15/ Trading is centered in London, where over 75% of this turnover occurs. 16/ Trades are executed over-the-counter ("OTC"), i.e., over the telephone, among a network of members of the Association of International Bond Dealers ("AIBD"). 17/

The AIBD, a voluntary SRO established in 1969, provides uniform rules for clearance, settlement and confirmation of

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15/ See supra Chapter II.

16/ While secondary Eurobond markets for the most part are institutional markets, smaller individual customers increasingly are participating (primarily through Swiss banks). Of course, many U.S. broker-dealers participate in the Eurobond market, principally through their overseas (largely London) affiliates. Generally, if U.S. customers seek to trade in Eurobonds, their orders are sent to these foreign affiliates for execution overseas. Nonetheless, trading in Eurobonds does occur in the U.S. although other international bonds trade more actively, particularly Yankee bonds (i.e., SEC-registered, dollar-denominated bonds of non-U.S. issuers).

17/ Some Eurobonds are listed on exchanges for technical reasons, principally because some European institutions may own only listed securities. In addition, West Germany requires Deutschemark bonds to be listed on a West German exchange. Very little trading occurs on the exchanges where the bonds are listed. Most of the listings are on the Luxembourg Exchange and the International (formerly London) Stock Exchange of the United Kingdom and the Republic of Ireland ("ISE"). International Finance Handbook, supra note 12, § 5.1, p.7.

trades. 18/ The AIBD, however, did not regulate trading until last year. In effect, each market sector, e.g., fixed-rate U.S. dollar bonds, Deutschemark bonds or floating-rate notes, developed its own practices and trading customs. 19/ In 1986, the Council of AIBD Reporting Dealers 20/ was formed with the goal of establishing several important trading and reporting obligations for AIBD dealers. Currently, there are 130 dealers registered as "reporting dealers" with the Council. 21/ Unlike other AIBD members, reporting dealers register with the Council

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18/ Indeed, the AIBD originally was formed to deal with the back office problems that virtually shut down secondary Eurobond trading in the late 1960s when primary market volume surged. See infra Section C.2.

19/ All dealers reported prices of Eurobonds in which they made markets to the AIBD weekly; the AIBD published the prices in the Weekly Guide to Eurobond Prices.

20/ The Council, whose members are AIBD members, is a separate subgroup of that organization, which enjoys a greater measure of autonomy than other AIBD committees. Telephone conversation between Alden S. Adkins, Branch Chief, Division of Market Regulation, and James Beecham, Chairman, Council of AIBD Reporting Dealers, January 30, 1987.

21/ These 130 dealers constitute the members of the Council. There are over 850 AIBD members in over 39 countries, including affiliates of the largest U.S. broker-dealers and banks. In addition to the new AIBD rules governing secondary market trades in Eurobonds, the International Primary Market Association ("IPMA"), a Eurobond underwriters group, has recommended that lead and co-lead underwriters of any fixed-rate Eurodollar bonds commit to make markets in the bonds for up to one year after the offering. See "Eurobond Group Sets Date on Market-making Rule," Wall Street Journal, June 2, 1987, p.51, and "Eurobond Group Asks Managers to Make Market in New Issues . . .", Wall Street Journal, June 15, 1987, p.40.

as dealers in specified Eurobonds and make two-sided quotations in a representative number of securities, a list of which is published weekly by the secretariat of the Council. More specifically, reporting dealers must undertake to make a two-way price to other members listed in the same securities at reasonable times, 22/ in minimum round lots, 23/ and in a "representative" number of securities. 24/

Each reporting dealer must communicate to the Council each Friday at the close of business the securities in which

22/ Reporting dealers for fixed-rate U.S. dollar issues must be available from 8:30 a.m. to 12:00 noon and 2:00 p.m. to 4:30 p.m.; reporting dealers for floating-rate note issues must be available from 9:00 a.m. to 12:00 noon and 1:30 p.m. to 4:30 p.m.; reporting dealers for Eurosterling issues must be available from 8:30 a.m. to 12:00 noon and from 1:30 p.m. to 4:30 p.m.; reporting dealers for European Currency Units ("ECUs") and composite currency issues must be available from 8:00 a.m. to 12:00 noon and 1:30 p.m. to 3:30 p.m.; finally, reporting dealers for Euroyen issues must be available from 9:00 a.m. to 12:00 noon and 2:00 p.m. to 4:00 p.m. See Rule III(6) of the Rules of the Council of Reporting Dealers, May 1987. The Council has not established trading hours for other Eurobonds.

23/ Round lots for fixed-rate U.S. dollar issues are set between \$100,000 and \$500,000 nominal value (\$100,000 for inactive and older issues); the agreed trading size for floating-rate note issues is one million (price is negotiable below one million); for Eurosterling issues, round lots are set between \$100,000 and \$500,000; round lots for ECU issues are set between \$100,000 and \$500,000 for active issues (*i.e.*, outstanding amount is at least ECU 50 million and there must be at least 4 reporting dealers in the issue), and between \$100,000 and \$250,000 for older and inactive issues; round lots for Euroyen issues are set between yen 50 million and yen 100 million. Id. Rule III(5). The Council has not yet established minimum lot requirements for other Eurobonds.

24/ The Council's rules do not specify what constitutes a representative number.

it will make two-way quotations to other reporting dealers the next week. 25/ If a particular security is withdrawn from the previously disclosed list during the course of a week, the reporting dealer must notify the secretariat. The rules differ, however, for reporting dealers in floating-rate notes, Euro-Sterling issues, ECU and composite currency as well as Euroyen issues. 26/ If a dealer fails to provide two-sided quotations in securities on its list during the following week without prior notice to the Council, it can be deregistered, i.e., it would be removed from the weekly list of reporting dealers, and, therefore, its quotations would no longer be published as quotations of an AIBD reporting dealer. Each reporting dealer also must report its daily closing quotations to the Council,

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25/ Different procedures apply for the last week of each calendar year. Id. Rule III(1)(c).

26/ Reporting dealers in floating-rate notes and Eurosterling issues may withdraw securities from the previously disclosed list after the close of each trading session and must notify the secretariat of such withdrawal. Reporting dealers in ECU and composite currencies must continue to make two-sided quotations for five working days after notification of withdrawal to the secretariat, or for one week after omitting such securities from the weekly list, whichever is the longest. Reporting dealers in Euroyen issues must give one business day's notice when withdrawing securities from the previously disclosed list. A notice of withdrawal must be sent to the secretariat as well as to all other reporting dealers making two-way quotations in the same securities.

and its daily high and low prices. 27/ The AIBD will publish these quotations and prices the following day. 28/

The AIBD rules also provide for the registration or "listing" of inter-dealer brokers, of which there are currently six. These inter-dealer brokers are required to effect transactions exclusively between reporting dealers and are not allowed to effect business with other entities (e.g., retail customers). 29/ While currently inter-dealer brokers operate over the phone, two firms recently announced an intent to establish blind inter-dealer brokering screens for Eurobonds similar to those used in U.S. government securities markets. 30/

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27/ The Council reports that, as of the end of June 1987, about 110 of the 130 reporting dealers were complying with these requirements, while others were slower in establishing the data communications systems necessary to fulfill the reporting requirements. Telephone conversation, supra note 20.

28/ Eurobond prices also are collected from dealers and disseminated by vendors such as Telerate and Reuters. Reuters collects data from approximately 340 different Eurobond dealers located in different countries covering the full spectrum of Eurobonds (i.e., all currencies, fixed-and floating-rates). These dealers submit quotations directly to Reuters, and are encouraged to keep the quotations as current as possible.

29/ This restriction arises from dealers' concern that inter-dealer brokers would compete with dealers by effecting trades with customers. "The City Revolution, Pragmatic Approach to City Rules," Financial Times, October 27, 1986, p.26. It should be emphasized, however, that these rules are the rules of the reporting dealers, and the inter-dealer brokers have not yet agreed to them.

30/ "Eurobond Broker is Planned," New York Times, February 19, 1987, p.D17. The two firms have recently applied for AIBD membership; however, they have not yet applied for registration as inter-dealer brokers.

The Council and the AIBD itself are considering registration under the new Financial Services Act 31/ as a Designated Investment Exchange ("DIE") as an alternative to registering as a Recognized Investment Exchange ("RIE"). 32/ Discussions are still underway between the AIBD and the SIB; prior to registering as a DIE, the AIBD probably will have to make some adjustments. A significant requirement will be the reporting of trades by United Kingdom members. Such reporting could be made through the newly proposed "TRAX" system. The TRAX system recently was proposed at the AIBD meeting in Oslo primarily to deal with the number of failed trades, which are estimated to be between 10% and 15% of all Eurobond trades. 33/ The system will require

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31/ The "Financial Services Act 1986" was enacted (received Royal Assent) on November 7, 1986. While the AIBD functions in part as an SRO in the generic sense of the term, the AIBD does not intend to seek registration as an SRO under the Financial Services Act. AIBD dealers operating in London, therefore, will have either to join some registered SRO or register directly with the newly established Securities and Investments Board ("SIB"). As a result, they will be subject to certain requirements concerning sales practices and financial responsibility rules.

32/ The Financial Services Act requires that trades not effected on either an RIE or DIE be reported directly to the SIB, the newly authorized securities market regulatory authority in the United Kingdom. The chief difference between an RIE and DIE is that an RIE is subject to closer SIB scrutiny of its rules and surveillance processes. See generally Sir Kenneth Berrill, The London Regulatory Scheme, Securities Industry Association ("SIA"), International Capital Markets Review, October 20, 1986.

33/ See "Britain's Bid to Regulate Eurobonds Still Has Dealers Wary Outside U.K.," Wall Street Journal, May 26, 1987, p.52.

dealers to report trades within 30 minutes of execution. The trades will be matched later by the AIBD, but will not be publicly disseminated. "TRAX" will not be ready for operation before the Fall of 1988. 34/

The AIBD had considered the possibility of implementing a screen-based quotation dissemination and display system for Eurobonds similar to the National Association of Securities Dealers, Inc., Automated Quotation System ("NASDAQ"). Many of the largest houses rejected such a possibility because their trading practices are incompatible with such a system; the AIBD instead determined to proceed at this time with the TRAX system as a less drastic change to their traditional method of dealing. 35/

## 2. Eurobond Settlement: Euroclear and Cedel

Growth in the Eurobond market in the late 1960s created pressure for the establishment of centralized automated clearance and settlement mechanisms. At that time, the Eurobond market experienced problems similar to those that plagued U.S. equity markets: cumbersome physical settlement practices, late or failed deliveries, risk of physical loss of securities and resulting back office failures. 36/ Thus, to fill the need for

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34/ Telephone conversation with James Beecham, June 8, 1987.

35/ Telephone conversation between Victoria Berberi, Attorney, Division of Market Regulation, and Jon Wolters, Secretary General of the AIBD, June 10, 1987. See also "Screens and Roundabouts," The Economist, May 16, 1987, p.66; and "Eurobond Dealers Reject Plan for Screen-Based Quotations," Financial Times, May 13, 1987, p.1.

36/ Apparently, the need to deliver securities certificates in cross-border settlements on a trade-by-trade basis, high-volume trading in those securities, and the prevalence of bearer-form securities contributed to settlement delays and financial losses.

automated clearance and settlement facilities, Eurobond market participants formed the Euroclear System ("Euroclear") and the Centrale de Livraison de Valeurs Mobilieres ("Cedel") -- the first truly multinational clearance and settlement systems.

Euroclear was formed in 1968 in Brussels by Morgan Guaranty Trust Company under Belgian law. In 1972, ownership was transferred to 120 banks and securities firms, none of which may own over 4% of the issued stock. 37/ Euroclear is subject to regulation by the Belgian Banking Commission. Belgian law governs Morgan Guaranty's liability as custodian and Euroclear's facilities manager as agent for its members. 38/ As of December 31, 1986, 2,053 banks, brokers, depositories and investment management firms were Euroclear members. Currently, \$402 billion in securities, including almost two-thirds of the entire Eurobond market, are on deposit in Euroclear. During 1986, \$2.3 trillion in transactions were cleared and settled through Euroclear facilities. This represents approximately 22,588 transactions per day; 96% were settled by book-entry.

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37/ The Euroclear system is owned by Euro-clear Clearance System Public Limited Company (U.K.) ("ECS"). Approximately 120 banks, financial institutions and dealers active in international securities markets are ECS shareholders. ECS has administrative offices in Zurich, Switzerland. Morgan Guaranty Trust Company, through its New York and Brussels branches, operates Euroclear's systems under a facilities management contract with ECS. ECS, however, must approve all custodians.

38/ Because Morgan Guaranty (Brussels) is a branch of the Morgan Guaranty Trust Company, it is subject to regulation by the New York and U.S. banking authorities.

Cedel was established in 1970 in Luxembourg and is subject to regulatory oversight by the Institut Monetaire Luxembourgeois (Luxembourg Monetary Authority), the national banking control authority. Cedel is owned by 95 banks and securities houses. Similar to the limitation on ownership placed on Euroclear shareholders, each Cedel shareholder may hold no more than 5% of the issued stock. Cedel's 1,400 members are a geographically diverse group of banks, depositaries and securities firms. Cedel currently has \$150 billion of securities on deposit. During 1986, \$1.2 trillion in transactions were cleared and settled through Cedel facilities.

Cedel and Euroclear offer members a broad range of services including an automated delivery versus payment clearing system, book-entry settlement and custody 39/ and related services (i.e., interest and principal collection). 40/ These services are described in greater detail below.

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39/ Securities may be deposited on a fungible or non fungible basis, at the participants' option. (Members occasionally are required by their domestic laws to hold securities that can be identified specifically by certificate number and thus may be required to deposit securities on a non-fungible basis.)

40/ Cedel and Euroclear also provide special services for members, such as exercising warrants, processing conversions and distributing allotments.

(a) Clearance and Settlement

Cedel and Euroclear provide clearance and settlement services 41/ to members for trades in eligible securities issues. 42/ At least one day before the settlement date (as determined by the parties at the time of the trade), each party to a trade must submit settlement instructions to the clearing system. The instructions are checked, matched against counterparty instructions and reported back to the parties. The clearing system only will act on matched instructions; thus, unmatched instructions must be resubmitted by one or the other party. On the settlement date, if the seller has sufficient securities on deposit, the clearing system will reduce (debit) the seller's securities account and increase (credit) the buyer's securities account, in accordance with the parties' instructions. 43/ At the same time, the clearing system will debit the buyer's, and credit the seller's, cash accounts, in

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41/ Generally, Euroissue trades settle seven calendar days after the trade. Euroclear and Cedel do not provide trade comparison services. Accordingly, members must communicate (e.g., by phone, cable or telex) after trade execution to verify the terms of the trade. Once agreement is reached as to the terms of the trade, members can proceed to submit settlement instructions to Euroclear and Cedel.

42/ Euroclear has facilities to settle trades in 20 different currencies. Cedel has facilities to settle transactions in 26 currencies.

43/ If the seller lacks sufficient securities to complete the delivery, the seller may be able to borrow securities from other clearing system members. See Section C.2.c. infra.

accordance with the matched settlement instructions. Settlement is in same-day (i.e., immediately available) funds.

Securities and cash accounts are essentially computerized journal or ledger entries indicating rights to securities and cash. Members receive daily settlement and securities position reports.

Both systems settle securities delivery and payment obligations on a trade-by-trade (instruction-by-instruction) basis. Neither system nets one member's delivery obligation with that same member's anticipated receipt of securities in the same securities issue, among other reasons to minimize losses due to member defaults. 44/ Accordingly, the clearing systems act exclusively in an agency capacity for each member and do not guarantee member payment or delivery obligations, as U.S. clearing agencies do with respect to member trades accepted for settlement through CNS systems. 45/

(b) Securities Custody

Transfer of ownership in securities is accomplished by electronic book-entry movements on the clearing systems in

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44/ In contrast, U.S. clearing agencies offer "net" accounting for settling securities and cash payments. All of a member's obligations to deliver securities in a particular issue can be netted against that member's obligations to accept securities in that issue on the same day ("deliver balance order systems") or, in addition, the net deliver or receive obligations can be netted against any outstanding fails to receive or deliver from previous settlement days in the same issue ("continuous net settlement systems" or "CNS" systems).

45/ See id.

Luxembourg and Brussels. The physical securities certificates, however, are held by custodian banks ("depositories") located around the world. Cedel's network of depositary banks includes 33 institutions and Euroclear's network includes 26 institutions. In each system, all the securities certificates of a specific issue are held by one bank, usually the bank responsible for paying dividends or interest on behalf of the issuer. 46/ Because of the custodian's proximity to the issuer's transfer agent, withdrawals can be expedited and transfer-related losses can be minimized. 47/ Moreover, appointing the issuer's paying agent as custodian for that issue may speed dividend and interest payments, reduce reconciliation and payment claim processing costs, and minimize confusion concerning local tax and transfer requirements.

(c) Bond Borrowing and Lending Program

Euroclear and Cedel also offer their participants a "bond loan" program similar to that offered by U.S. clearing agencies. 48/

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46/ Some securities held by the depositary banks are, in turn, deposited with a clearing agency in their home country. For example, Morgan Guaranty, as depositary for Euroclear, uses the Depository Trust Company, as its sub-custodian. Additionally, certain securities in book-entry form are held in local national book-entry systems, analogous to the U.S. Federal Reserve System's book-entry system.

47/ For example, risks of loss or theft, and related insurance and shipping costs, can be reduced dramatically.

48/ In 1981, Cedel expanded its program to permit participants to provide Cedel with standing instructions to monitor participant accounts automatically and to borrow or lend securities as needed.

The clearing systems initiated these programs in response to member demand for securities either to effect short sales or to ensure delivery of securities on settlement date. The programs have reduced the number of "fails" in the Eurobond market. The borrower's obligation to return securities is guaranteed by a syndicate of guarantor banks, in return for which the borrower must pledge adequate collateral to the syndicate in the clearing system. This syndicate determines what collateral borrowers must pledge (e.g., cash and/or securities).

(d) Financing

Euroclear and Cedel also offer financing services to members that participate in the Eurobond market. Many Eurobond dealers use this service to finance their inventory. 49/ As security for these loans, Euroclear and Cedel take a security interest in securities being financed. Euroclear and Cedel also require borrowers to provide collateral, including letters of credit.

(e) Cedel-Euroclear "Bridge"

In 1971, Cedel and Euroclear entered into an agreement to "bridge" the two clearing systems to facilitate the settlement of transactions between participants in each system. Each day, Cedel and Euroclear exchange information, such as member settlement instructions. Thus, settlement of securities and the

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49/ At Euroclear, financing is provided by Morgan Guaranty Trust Company. At Cedel a group of member banks provide financing.

transfer of cash on settlement date between participants of the two clearing systems no longer are dependent on the physical delivery of bonds.

D. International Equity Markets

It has become commonplace to refer to the development of 24-hour trading markets in equity securities. To some extent this characterization is correct. There are now nearly 500 companies whose shares are listed and traded outside their home countries. 50/ This trading occurs both on the floors of foreign stock exchanges and in the OTC market.

While international trading of equity securities exists, that trading is limited, particularly with respect to U.S. securities. First, it appears that very little foreign trading in U.S. securities occurs during U.S. trading hours. Second, conversations with broker-dealer firms indicate that trading in U.S. securities overseas occurs almost entirely among foreign investors and sophisticated U.S. institutional investors. 51/ Third, the amount of trading in U.S. securities that takes place on foreign markets is a small fraction of trading

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50/ Address by John Shad, Chairman, SEC, before the International Association of Securities Commissions, on July 16, 1986.

51/ See remarks of Donald Unruh, Vice President, Toronto Stock Exchange ("TSE") at the SEC's Internationalization Roundtable (Summary, Appendix B).

volume in the U.S., 52/ barring unusual overnight news regarding a company. 53/ Home market dominance has been less pronounced for certain foreign securities traded in the U.S. and in the United Kingdom; 54/ nonetheless, the home country tends to remain the primary market and there is no well-developed integrated multinational secondary market for equities as there is for Eurobonds. 55/

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52/ Some firms indicate that a great deal of London's volume in U.S. shares occurs on the day futures and options on stock indexes expire (so-called "triple witching hours"), with the U.S. firms guaranteeing the New York Stock Exchange ("NYSE") close for their customers closing out index arbitrage positions and then executing the trades in London after the NYSE closes. This allows the firms to avoid the congestion that occurs at the close on the NYSE on these days.

53/ For example, the ISE indicates that its members reported that on average they traded approximately \$46 million daily in U.S. stocks in the first six months of 1987. In addition, traders estimated that during the first part of 1986 the daily volume in U.S. stocks in London's off-exchange market was \$100-150 million. See Putka, "Foreign Issues Flood London OTC trade," Wall Street Journal, April 18, 1986, p.24. Both figures represent a relatively small proportion of total volume in U.S. stocks. For example, average daily NYSE dollar volume in May 1987 was over \$7.1 billion; on the American Stock Exchange ("Amex") \$176 million; and on NASDAQ \$1.9 billion.

54/ For example, some American Depositary Receipts ("ADRs") covering United Kingdom shares (e.g., Jaguar) are among NASDAQ volume leaders and trade twice as actively in the U.S. as the underlying shares trade in the United Kingdom. Trading in Canadian shares in the U.S. is also very active. In addition, a recent estimate indicated that about 80% of trading in Swedish shares and over 20% of trading of French shares may occur on the ISE. See remarks of Robert D. Meyjes, Senior Vice President, Citicorp Investment Bank, at the SEC's Internationalization Roundtable (Summary, Appendix B).

55/ Most of the transnational trading in equities occurs via a network of large multinational firms and institutions. See infra Section E.

Recent developments, particularly the deregulation of markets in the United Kingdom, 56/ suggest that the degree of worldwide competition for equity securities may increase in the future. For example, several large foreign firms with substantial amounts of capital have established affiliates in the United Kingdom. 57/ This massive infusion of capital provides the potential for liquid markets in a wide range of international equity securities. In regard to U.S. securities, the new market making activities of affiliates of U.S. broker-dealers in London may encourage the U.S. dealers to pass books 58/ or open institutional orders for execution after NYSE trading hours.

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56/ The development of the new United Kingdom regulatory structure (sometimes referred to as "Big Bang") generally is understood to be comprised of four major components: (1) the removal of restrictions on foreign ownership of United Kingdom securities firms (March 1986); (2) the unfixing of commission rates and the abolition of the former London Stock Exchange's ("LSE") prohibition against a firm serving as both broker and market maker (October 27, 1986); (3) the implementation by the ISE of a new screen-based trading system (the Stock Exchange Automated Quotation or "SEAQ" System) (October 27, 1986); and (4) the enactment, in November 1986, of the Financial Services Act, which requires securities firms either to become members of an SRO or to register directly with the SIB.

57/ It also should be noted that Canada and France recently have undertaken to liberalize their rules regarding foreign ownership of financial firms and that Japan has taken some steps to allow greater foreign broker-dealer participation in its markets. See supra notes 7 and 8.

58/ "Passing the book" generally is passing control over a firm's proprietary trading activity from one group of a firm's dealers to another group located in a different time zone. Control over the proprietary position encompasses several components, including location of the inventory, profit and loss accountability and control over immediate trading decisions. Some firms use the term "passing the book" to refer to the passing on of different of these components. As used here, "passing the book" refers to passing only control over immediate trading decisions.

Moreover, with the formation of the ISE as a result of the merger in 1986 of the LSE and the International Securities Regulatory Organization ("ISRO"), 59/ the London market has indicated that it will seek aggressively to attract volume in U.S. and other foreign shares. 60/ As part of this effort, the international equities segment of the ISE is moving to a screen based system called SEAQ International, 61/ similar to

59/ ISRO was formed in 1985 by the 187 largest Euroequity dealers to protect their interests as "Big Bang" developed. ISRO threatened to set up a rival stock exchange for the world's highest capitalization shares that would have drawn liquidity from the LSE in the large United Kingdom shares. Thus, the 1986 merger averted for the LSE a competing market for international shares. See, e.g., "London Stock Exchange: If You Can't Beat Them Join Them," The Economist, pp.94-95 (September 20, 1986); "Way Cleared for Merger of London Exchange, ISRO," Wall Street Journal, November 13, 1986, p.64.

60/ See Remarks of Jeffrey Knight, President, ISE, at the SEC's Internationalization Roundtable (Summary, Appendix B). The ISE already has had some success, attracting in the three months ended January 31, 1987, over \$507 million of volume a day in foreign securities. See "Foreign Equities Make Up Quarter of London Trades," Wall Street Journal, March 10, 1987, p.54. Approximately \$46 million of this volume was in U.S. shares. See supra note 53. In this connection, after the ISE's announcement of its intent to close its stock trading floor by 1988, the NYSE first indicated that it might interpret its off-board trading rule (Rule 390) to prohibit trading of NYSE listed stocks on the ISE by NYSE members during NYSE hours, and then indicated that as of this time it had not changed its interpretation allowing such trading. See "Big Board's Strict Interpretation of Rule Causes Furor at London Stock Exchange," Wall Street Journal, March 9, 1987, p. 5; and "Big Board Bows to U.K. on London Exchange's Status," Wall Street Journal, March 13, 1987, p.2.

61/ SEAQ International market makers generally are willing to deal in sizes higher than the minimum displayed. Firm quotes are governed by comprehensive dealing conventions

(footnote continued)

that implemented by the exchange for the domestic shares market. 62/

In addition to these developments, the absence of extraterritorial application of the Glass-Steagall Act permits U.S. and foreign banks to engage in dealer activities for U.S. securities in Europe that would be prohibited in the U.S. In particular, foreign banks may find it tempting to effect directly transactions with their advisory clients rather than to route those orders through U.S. broker-dealers to a U.S. exchange.

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(continued footnote)

to which all market makers agree to comply. There are formal market hours that apply to defined international regions during which hours all market makers in such region input quotes to the market. In addition, many firms continue to make firm prices after market hours and these, too, are displayed on the system. SEAQ International, pamphlet published by the London Stock Exchange, September 1986.

SEAQ International now carries about 620 issuers from 14 different countries. There are 46 market making firms from ten countries, including the United States. The ISE plans to upgrade SEAQ International to permit the inclusion of more stocks and market makers, and ultimately plans to replace SEAQ International with a new system on which 200 market makers could display prices for 1,500 non-United Kingdom equities. Nicoll, "London Bids to Become Leading International Share Trading Centre," Financial Times, February 4, 1987, p.1. Thus far, only Japanese and Dutch market makers are submitting trade reports at the end of each day; these trade reports are published on the system's screens. In the near future, the market making firms of other countries will submit reports; ultimately, all member firms will be required to submit trade reports to comply with reporting rules of the SIB.

62/ See infra note 82.

Some firms also have indicated that the Commission's short sale rule may drive some volume in U.S. shares offshore. Rule 10a-1 under the Securities Exchange Act, 63/ which is generally designed to prohibit short selling from accelerating a declining market, places certain restrictions on short sales in most equity securities traded on a national securities exchange. The short sale rule uses a tick test that compares the price of a proposed short sale to immediately preceding transactions to determine its permissibility; short sales may be effected only on a plus tick (i.e., at a price above the price at which the immediately preceding last sale was effected) or a zero-plus tick (i.e., at a price equal to the last sale if the preceding transaction at a different price was at a lower price).

In its 1985 Global Trading Release, 64/ the Commission requested comment, inter alia, on the application of Rule 10a-1 to short sales effected in international markets, noting that the rule does not contain an exemption for such short sales. In response, the SIA stated that it was unclear whether the rule was ever intended to apply to transactions effected in foreign markets, where the absence of continuous transaction reporting and the difficulty of ascertaining the last sale price for transactions effected at a time when U.S. exchanges

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63/ 17 C.F.R. § 240.10a-1.

64/ See supra note 2.

are closed would make compliance difficult. 65/ There is no clear exception from the short sale rule for international trades, and Commission's staff has not seen clear indication that any substantial trading occurs overseas for the primary purpose of avoiding the rule's requirements. The Commission's staff continues to monitor developments in this area.

A final factor that may over time increase overseas trading in U.S. equity securities is the potential emergence of a Euroequity market. As noted above, a variety of factors influenced the development of a vigorous Eurobond market, which continues today and appears to be expanding. If, in turn, U.S. issuers increasingly seek to raise equity capital abroad (i.e., in the so-called Euroequity market), such an occurrence could effect the development of more active secondary trading. For example, if an increasing number of foreign investors hold increasing amounts of U.S. equity securities, these investors may desire to trade those securities in their own countries. Moreover, if those securities were offered pursuant to terms and conditions which effectively precluded their ready resale into the U.S. market, those investors might very well seek to ensure that active, liquid secondary markets developed in

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65/ See letter from William R. Harman, Chairman, Federal Regulation Committee, SIA, to John Wheeler, Secretary, SEC, dated October 17, 1985.

London or elsewhere. At the present time, however, relatively few U.S. companies have issued equity securities in Europe. 66/

Despite all of the factors discussed above, there is no clear indication that the basic structure of trading in U.S. securities, focused on home market trading as the pricing mechanism, will change. Nevertheless, the existing degree of international secondary market trading, as well as its potential for increasing, raises a host of questions regarding the operations of multinational firms, the trading, clearance and settlement of international transactions and the ability of regulatory bodies to enforce their laws and regulations. The remainder of this chapter focuses on those questions.

#### E. Multinational Securities Firms

##### 1. General

This section describes the international operations of several U.S.-based multinational securities firms. 67/ The discussion encompasses a limited survey of U.S. and foreign multinational firms' operations and is not comprehensive either as to the types of firms described or as to their operations. Rather, it is intended to provide a sketch of the current global activities of some large U.S.-based multinational firms. 68/

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66/ See supra Chapter II.

67/ While this overview focuses chiefly on U.S.-based multinationals, it also highlights significant aspects of the U.S. operations of large foreign-based multinationals.

68/ The information contained in this section is based upon interviews with the U.S. offices of six large U.S.- and twelve foreign-based multinational firms, as well as other publicly available data.

It is difficult to generalize concerning the extent and manner of operation of U.S. multinational firms' international debt, equity and research operations. Each firm trades and provides research in a variety of products and emphasizes different foreign markets to different degrees. In addition, some houses centralize control over positions and trading decisions in their home offices, while others localize control in overseas offices, usually subject to various limitations, such as the amount of capital that may be committed to particular trades. As a general matter, control with respect to trading in a particular security will reside in the office located in the primary market for that security. For example, control over a multinational firm's trading in U.S. government securities most likely would be in the U.S. office.

The bulk of trading in foreign securities in the U.S., both in terms of volume and numbers of securities, occurs over-the-counter, either through NASDAQ or otherwise. Furthermore, while some U.S. exchanges are now linked to foreign markets, transnational transactions generally occur over the telephone in an OTC environment. Finally, the customers for these products and services are largely institutions rather than small individual investors.

## 2. International Debt Operations

While it is difficult to generalize for all multinational firms' international debt operations, some patterns

emerge. First, the customer base is almost wholly institutional. Second, the multinational U.S. firms, like their foreign counterparts, have offices in Tokyo, London and New York, as well as in other foreign locations. They also all trade a variety of international debt products denominated in a variety of currencies, including Eurobonds, government bonds (U.S., United Kingdom, Japan, West Germany and others) and foreign corporate debt securities. While each firm usually concentrates on particular market segments, such as non-U.S. corporate and government bonds denominated in various major currencies, Yankee bonds, or U.S. government securities, a few multinationals trade virtually the full spectrum of fixed-income and floating-rate corporate and government debt securities.

As a general matter, the U.S. operations of these firms focus on U.S. Treasury 69/ and Yankee bonds, 70/ whereas most Eurobond trading occurs in the Eurobond markets in London. 71/ Indeed, the primary trading markets for debt securities continue to be either the market of the currency in which the security is denominated or the Euromarket, and the multinationals often

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69/ An interesting account of 24-hour trading in U.S. Treasury securities at Merrill Lynch is contained in "A Day--and Night--in the Life of the Global Market," 20 Institutional Investor, No. 4, April 1986, pp.293-294, 302.

70/ According to one source, over 99% of all secondary market trading in Yankee bonds occurs in the U.S.

71/ See supra Section C.

centralize trading in the affiliate located in those markets. In addition, most of the U.S. affiliates of foreign-based firms concentrate on U.S. government securities, 72/ although they also are building corporate securities trading capacity.

The size of international debt security positions can be significant, reaching as high as \$1 billion. The number of personnel committed to this area of the multinational firms' operations varies, ranging from seven traders to as many as 72 in some overseas offices.

The manner in which multinational firms manage their proprietary positions also varies, although some generalization is possible. Some firms "pass the book" 73/ for debt instruments that are traded in multiple markets, with profit and loss accountability and inventory generally remaining in the office located in the primary (i.e., most active) market for each particular security. After the book passes, traders located in the primary market office will communicate with other offices to assure that trading is conducted properly. For example, the book for Eurobonds will be passed from London to New York to Tokyo. London, as the primary market, will be the profit and loss center and inventory will be maintained there. Because

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72/ The Federal Reserve Board recently named as primary U.S. government securities dealers the U.S. affiliates of Nomura and Daiwa, two of the so-called "Big Four" Japanese securities firms. (The other two are Nikko and Yamaichi.)

73/ See supra note 58.

little Eurobond trading occurs in the U.S., monitoring of the book in New York after it is passed will be largely perfunctory. When the book is in Tokyo, traders there will communicate with those in London before undertaking major commitments. For U.S. government securities a similar arrangement might prevail, with the New York office being the home or primary market.

Other firms that also pass the book retain ultimate authority over size of position and profit and loss accountability in the firms' home country rather than in the primary market for the security. Still another variation is to pass the book for multiply-traded debt securities and provide complete discretion over the firm's entire position to the office where trading is occurring. Profit and loss is determined product-by-product and there is no one individual profit center.

While most firms thus pass the book for various fixed income products to some extent, one firm indicated that it totally decentralizes overseas operations, with trading occurring almost exclusively in the firm's primary market office only and inventory being located there. Even under this type of arrangement, however, some instruments (e.g., U.S. Treasuries) may trade in more than one office. This firm expects to integrate its global efforts eventually. 74/

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74/ Because the Japanese firms located in the U.S. concentrate on U.S. government securities, their operations tend to be more uniform. The U.S. offices of these firms are

(footnote continued)

### 3. International Equity Operations

While the international equity trading operations of multinational firms are as varied as the fixed-income operations, again some generalization is possible. First, the equity trading operations of these firms are less well developed than their debt activities, reflective largely of the fact that development of international equity offerings markets, which is usually a precursor to active secondary market trading, has lagged behind the evolution of international debt offerings markets. Nonetheless, the multinationals all have equity operations in London, New York and Tokyo as well as other major markets in Europe and Asia. A few firms also have South American operations.

For the most part, the international equity operations of these firms originated as arbitrage desks, designed chiefly to capture price differentials between U.S. and foreign markets in equity securities (or receipts for those securities, e.g.,

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(footnote continued)

largely autonomous, although the London and Tokyo U.S. Treasury desks of these firms do communicate with the New York office. Indeed, one Japanese firm has completely separate New York and Tokyo books and inventories for U.S. Treasuries, because the offices serve different client bases and because the markets move in different directions during New York and Tokyo hours. The segregation is so complete that the Tokyo book has a representative in New York to trade for the Tokyo book. This allows the Tokyo book to trade 24 hours a day. The New York book does not have a trader in Tokyo, but does leave instructions in Tokyo after New York closes on how to trade the New York book if the market moves beyond certain parameters. This firm indicated that it expects to implement global accounting for its U.S. Treasuries book soon.

ADRs). From this beginning, international equity desks of the multinationals have evolved into more general dealer, agency and research operations. 75/ In the initial phases of that evolution, the primary focus often has been on the equity securities of the home base country, with a secondary emphasis on agency services in foreign securities for home base customers. The capacity to deal in and provide research for foreign securities usually comes later in this evolution. Thus, the Japanese and many of the British firms doing business in the U.S. focus their equity business on Japanese and United Kingdom equities, respectively, and in addition provide agency execution services to their parents' Japanese and British customers in U.S. securities. 76/ As with the debt side, the size of these equity operations varies, with some

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75/ Research is discussed separately in the next section.

76/ With the increase of Japanese investors' interest in U.S. equity securities, due in part to decreasing yields on U.S. government securities, this part of the Japanese firms' business has grown dramatically. During the first quarter of 1987, the Japanese have traded a total of \$17,728 million of U.S. equities, compared to \$9,863 million during the last quarter of 1986. Moreover, net purchases by Japanese investors have increased from \$688 million in the last quarter of 1986 to \$3,495 million in the first quarter of 1987. Securities Industry Association, Foreign Activity, Volume X, No. 4, June 19, 1987, p.5. See also "Japanese Lifetime U.S. Investment," 15 Pensions and Investment Age, March 23, 1987, p.1. One major Japanese firm recently decided to direct the equivalent of \$10.4 billion of its customers' investments into non-Japanese (mostly U.S.) equity securities. This would represent an eight-fold increase over this firm's 1986 activity in U.S. equity securities.

of the major multinationals having as many as 300 to 400 professional personnel in offices located in foreign markets. The customer base for these international equity services is largely institutional.

There is some similarity in the way trading is coordinated among the foreign and domestic offices of the multinationals. First, the home country markets for even world-class international equities continue to be the primary markets, 77/ and orders received in foreign offices often may be routed there for execution. Nonetheless, active trading does occur in the various desks not located in the home country for these securities and in the organized (generally exchange) foreign markets for some securities. Indeed, U.S. markets for ADRs on several United Kingdom shares exhibit greater volume than reported in the United Kingdom for the underlying share. 78/

Even where foreign desks are active, many firms centralize management in the firm's home country, with that office exercising day-to-day control over profit and loss and inventory. The overseas affiliates, however, necessarily are often free to make day-to-day trading decisions because of the difficulty in consulting with the home office after-hours. In essence, these firms are allowing their London, Tokyo and New York desks increasing autonomy, with the book passing from time zone to time zone.

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77/ See supra Section D.

78/ Id.

Some U.S. multinational firms follow a different pattern, centralizing management in the primary market country rather than in New York. For example, the London and Tokyo offices will trade largely United Kingdom/European and Japanese stocks, respectively, 79/ with the book passing during the off-hours of these offices but with the London and Tokyo offices retaining control over size of position, profit and loss, and inventory. 80/

Interestingly, the Japanese multinationals tend to employ a different structure, with the total capital committed to various overseas equity operations controlled by the home country parent, but with the foreign offices operating virtually autonomously in terms of day-to-day management and trading decisions.

The multinationals all depend upon various sources of market information for equities, primarily, of course, relying upon the vendor services available in the different national

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79/ This is not to suggest that U.S. firms do not make markets in U.S. stocks abroad. Indeed some U.S. firms are aggressively establishing dealer operations in U.S. securities in the United Kingdom's new international equities markets. See supra Section D. Nonetheless, to date, as with securities of other countries, the U.S. remains the primary market for U.S. securities.

80/ While most multinationals follow one of these two patterns -- with management centralized either in the home office or in the primary market office, and with the book passing, at least one U.S. firm has centralized management of its international equity operations in London.

markets. 81/ For the most active and highly-capitalized U.S. equity securities there is real-time price quotation and volume information, 82/ and, in the United Kingdom, there is now similar information for the 105 "alpha," or the most actively traded United Kingdom securities. 83/ Far less information is available in other markets, and the information

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81/ See Rules 11Aa3-1, 11Ac1-1 and 11Ac1-2 under the Securities Exchange Act, 17 C.F.R. 240.11Aa3-1, 11Ac1-1 and 11Ac1-2, relating to transaction and quotation reporting and vendor display requirements.

82/ For "alpha" stocks, market makers show firm, continuous two-way prices, and all trades are published immediately on the ISE's SEAQ system. See supra note 61. The information is then disseminated by TOPIC Services, Inc. ("TOPIC"), the Exchange's electronic data dissemination service, which is available in the U.S. In other less actively traded stocks, called "beta" stocks, of which there are 547, market makers display continuous two-way quotations, but the trades are not published until the end of the day. There also are 1,436 "gamma" stocks, relatively inactive stocks in which market makers show continuous two-way quotes, but for which prices may be indicative rather than firm and for which trades are reported but not published. The minimum quotation size on SEAQ is 1,000 shares, for both bid and ask prices. Market makers' quotes generally are for 25,000 shares and may go up to 100,000 shares, depending on the stock. For blocks of shares greater than the quoted number of shares, potential buyers and sellers must contact directly the quoting market makers to arrange a sale. By the end of 1987, however, the ISE anticipates installing a screen-based block order exposure system, in which member firms will input large orders for display. The ISE also has a SEAQ International service for international equities. See supra Section D.

83/ These services not only provide means to receive information, but also to disseminate information. Thus, firms can quote markets electronically around the world without a physical presence outside their home country. The regulatory issues raised by this are discussed infra Section E.5.

that is available is not consolidated globally. 84/ Thus, most firms will maintain an assortment of vendors' services and machines in their international trading rooms, in addition to relying upon less formal sources of market information (e.g., local telephone contacts in different markets). 85/

Like the international fixed-income desks, the multinationals' equity operations coordinate closely with these firms' foreign currency operations. These firms generally have the capacity to quote and execute trades in the home country currency of many different world-class equities.

#### 4. Research

The international research capacity of the multinationals has just begun to develop, representing a later stage in the evolution of these firms' overall international equity operations. United Kingdom firms were the single exception; at an early stage, they developed sophisticated research capacities for non-United Kingdom securities, at first principally U.S. securities.

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84/ At least one vendor, however, disseminates globally information on equities from numerous different exchanges. Although the information can be provided on one single page, the quotes are not consolidated, and moreover, are denominated in the currency used on each exchange.

85/ Some multinationals do indicate that they seek to obtain some rough measure of global best execution for world-class securities, endeavoring to check other foreign markets open at any one time to ascertain the best price. Because of differences in quotation practices, foreign currency conversion problems, and vastly different clearing and settlement and other transaction costs, this is an extremely difficult assessment to make. In part because of this, some firms indicate they do not attempt to undertake it.

Other multinationals now are devoting increasing attention to international research; indeed, most now have analysts located in Tokyo, London, New York and other major markets. The research being produced is increasingly global in scope, designed to provide coverage of all the major companies worldwide in particular industries. Thus, while analysts located in the home country of an issuer still will be primarily responsible for research on that issuer, the multinationals aim ultimately to integrate these reports into one worldwide report on specific industries. With the advances in telecommunications, firms are now able to disseminate research reports worldwide electronically, via either their own internal systems or various vendor services, so that almost instantaneously globally disseminated research reports are becoming available. 86/

## 5. Regulatory Oversight

### (a) Financial Responsibility

Regulatory oversight of large multinational firms actively conducting a securities business in many different countries is difficult. Perhaps the chief concern is to ensure the financial integrity of these firms. 87/

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86/ See *infra* for the regulatory concerns raised by this capability.

87/ See, e.g., remarks of Robert Birnbaum, President, NYSE, at the SEC's February 17, 1987, Internationalization Roundtable (Summary, Appendix B).

Although the staff is not presently aware of specific problems, the increased internationalization of securities markets has raised concern about the ability of the Commission and the SROs to ensure the financial integrity and responsibility of U.S. registered broker-dealers. The Commission and the SROs lack the authority to examine and regulate the activities of unregistered overseas affiliates of U.S. registered broker-dealers. 88/

It should be noted that the Commission does not have the authority to extend its recordkeeping rules, Rules 17a-3 and 17a-4 under the Securities Exchange Act; 89/ the net capital rule, Rule 15c3-1 under the Securities Exchange Act; 90/

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88/ Many major international securities firms are organized as holding companies which own all of the stock of related entities conducting business in specific securities markets worldwide. The growth of the securities business of U.S. securities firms in Europe and the Far East has increased steadily in recent times. For example, one large U.S. firm, a New York-based holding company with offices in the United States, Canada, England and Japan, increased its revenues from overseas operations as a percentage of total revenues from approximately 5.3% in 1983 to 12.3% in 1985.

89/ 17 C.F.R. 240.17a-3 and 17a-4.

90/ 17 C.F.R. 240.15c3-1. Rule 15c3-1 specifies minimum levels of net capital required to be maintained by a registered broker-dealer, based on the nature of the broker-dealer's business. The amount of required net capital is expressed as a ratio or percentage of a firm's aggregate indebtedness, or alternatively, its customer debits or receivables. Aggregate indebtedness is a defined concept that includes most monetary liabilities of a broker-dealer. For broker-dealers using the aggregate indebtedness method, aggregate indebtedness may not

(footnote continued)

or other financial responsibility rules to non-registered broker-dealers, who may be affiliated with registered broker-dealers.

The Commission's net capital rule does provide some safeguards to protect the stability and integrity of a registered U.S. broker-dealer from the defaults of its affiliates. Should a U.S. registered broker-dealer guarantee the obligations of its affiliates, the Rule requires it to consolidate in a single computation the assets and liabilities of that subsidiary or affiliate. In this instance the SRO would have access to examine the activities of the registered broker-dealer and the activities of its guaranteed affiliate.

In addition, paragraph (e) of the Rule prohibits the withdrawal of equity capital by a registered broker-dealer if the withdrawal would cause the firm's level of net capital to decline to certain prescribed "early warning" levels (which are in excess of minimum net capital levels). It thus provides a prohibition against the withdrawal of capital to benefit an affiliate experiencing financial difficulty if such withdrawal could possibly endanger a registered broker-dealer's financial stability.

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(footnote continued)

exceed 1500% of net capital or, stated another way, the firm's net capital must be at least  $6 \frac{2}{3}\%$  of its aggregate indebtedness. The second or "alternative" method is based on customer debits (i.e., customer receivables) as calculated under Rule 15c3-3, 17 C.F.R. 15c3-3, and requires a broker-dealer to maintain net capital equal to 2% of aggregate customer debits.

Registered broker-dealers often transact business with affiliated unregistered companies creating a receivable due from the affiliate to the registered broker-dealer. Unsecured receivables from an affiliated company are not deemed to be includable assets for net capital computation purposes. Thus, some protection from fictitious or dishonest intercompany transactions is provided by this provision in the Rule. Because of its limited jurisdiction, the Commission staff has found it extremely difficult to trace the movements of funds and securities necessary to reconstruct transactions between affiliates. To alleviate this problem, the Commission recently amended its net capital rule to provide that any secured receivable from an unregistered affiliate be deducted from net worth unless the affiliate makes available upon request its books and records to the Commission and/or the registered broker-dealer's Designated Examining Authority. 91/

A recent proposal for relating minimum capital requirements to the risk profiles of banking organizations, developed jointly by representatives of the Bank of England, the U.S. Office of the Comptroller of the Currency and Federal Reserve

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91/ See Securities Exchange Act Release No. 24553 (June 4, 1987), 52 FR 22295 (June 11, 1987). A Designated Examining Authority is the SRO designated by the Commission to examine a broker-dealer to ensure the broker-dealer is complying with the Commission's financial responsibility rules.

Board, illustrates cooperation between governments that can enhance global regulation of financial markets through the adoption of uniform rules. 92/

(b) Foreign Broker-Dealers' Activities in the U.S.

Securities Exchange Act Section 15(a) requires any broker or dealer who uses the mails or any means or instrumentality of interstate commerce ("the jurisdictional means") in effecting any transaction in or inducing the purchase or sale of any security to register with the Commission, unless otherwise exempted. The definitions of "broker" and "dealer" in the Act apply to "any person" without regard to citizenship; therefore, Section 15(a) applies to foreign broker-dealers using the U.S. jurisdictional means to offer or sell securities within the jurisdiction of the U.S. 93/

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92/ The original proposal was released for public comment on January 24, 1987. See 52 FR 5119 (February 19, 1987), 52 FR 18703 (May 19, 1987).

93/ Section 30(b) of the Act excludes the application of the Act or the rules thereunder to "any person insofar as he transacts a business in securities without the jurisdiction of the United States," in the absence of Commission rules explicitly applying these provisions to such person. No rules have been adopted. However, the exemption provided by Section 30(b) has been construed to be unavailable where the transactions occur in a U.S. securities market, Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), rev'd on other grounds, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied sub. nom Manley v. Schoenbaum, 395 U.S. 906 (1969); Roth v. Fund of Funds 405 F.2d 421 (2d Cir. 1968), or where offers and sales are made to U.S. citizens or in the U.S. to facilitate sales of securities abroad. SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973).

Application of broker-dealer registration requirements to foreign broker-dealers engaging in business in U.S. markets furthers the purposes of Section 15(a) of the Act of protecting investors and maintaining the integrity of the U.S. securities markets. It assures that investment intermediaries who solicit U.S. securities transactions satisfy basic competency, capital and reporting standards, comply with customer protection requirements, and have consented to U.S. jurisdiction for purposes of SEC enforcement and civil actions.

However, the Commission staff has not required broker-dealer registration in all instances where foreign broker-dealers have employed the U.S. jurisdictional means. In determining when registration should be required, the Commission staff has focused on the degree to which a foreign broker-dealer solicits U.S. investors to purchase or sell securities and on the extent to which that broker-dealer is involved in transactions occurring in U.S. markets. Where the activities of a foreign broker-dealer do not involve U.S. investors or significant participation in U.S. markets, registration of that broker-dealer generally has not been required.

Key to the issue of solicitation is whether the foreign broker-dealer's contacts with U.S. markets reasonably may be viewed as attempting to induce an investor's purchase or sale of a security. The staff historically has taken a strict view of what solicitation entails. The staff has considered activities such as placing advertisements in the U.S. newspapers or hosting

an investment seminar in the U.S. to constitute solicitation and thus to require broker-dealer registration for a foreign broker-dealer. 94/ However, several recent Commission and staff actions have adjusted these positions somewhat in light of the increasing internationalization of the marketplace accomplished in part through electronic linkages of foreign and U.S. exchanges. The Commission has sought in these actions both to accommodate the growing internationalization of the securities markets and to carry out its primary obligation to protect U.S. investors.

First, on April 21, 1986, the Commission approved a pilot program jointly undertaken by the NASD and the ISE that makes certain market information, including securities quotations by market makers, available in both Great Britain and the U.S. 95/ Shortly thereafter, the Commission's Division of Market Regulation issued a temporary no-action position with respect to the ISE/NASD quotation link, allowing the quotes of foreign market makers entered into the ISE's SEAQ system to be disseminated in the U.S. through the NASDAQ system and trades resulting from those quotes to be executed without either the foreign market

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94/ See letter from David J. Romanski, Attorney, Office of Chief Counsel, Division of Market Regulation, to Hugh Seymour, Hoare & Govett, Ltd., dated September 28, 1973.

95/ See discussion infra Section F.1. on Market Linkages; Securities Exchange Act Release No. 23158 (April 21, 1986), 51 FR 15989.

makers or the ISE registering as broker-dealers. 96/ In issuing this letter, the staff maintained that there were substantial grounds for concluding that the foreign market makers, with the aid and assistance of the ISE, were effecting transactions in securities for purposes of Section 15(a) of the Act. Further, the staff emphasized that any activities resulting in substantial U.S. contacts or involving the solicitation of U.S. investors other than through the entry of quotes through NASDAQ were expressly beyond the scope of the letter. 97/

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96/ See letter from Mary Chamberlin, Chief Counsel, Division Of Market Regulation, to Frank J. Wilson, Executive Vice President and General Counsel, NASD, dated May 7, 1986. This position has been extended several times, most recently until December 31, 1987. See letter from Robert L.D. Colby, Chief Counsel, Division of Market Regulation, to Frank J. Wilson, Executive Vice President and General Counsel, NASD, dated June 9, 1987.

97/ The provision of quotes on foreign exchange-traded securities was also addressed in a November 1986 temporary no-action letter granted to members of the ISE that are market makers in ISE-listed securities and that make their quotes and other information available to U.S. subscribers of TOPIC. See letter from Robert L.D. Colby, Chief Counsel, Division of Market Regulation, to Richard B. Smith, Davis, Polk & Wardwell, dated November 28, 1986. The nature of the information made available through TOPIC was substantially similar to, though more extensive than, that provided through NASDAQ under the pilot program, including quotes on a wider range of financial instruments. The no-action letter permitted recognized market makers in ISE-listed equity securities to display via TOPIC terminals in the U.S. competing two-way quotations as they were reported in the ISE's SEAQ system. The TOPIC letter did not cover a SEAQ market maker if it engaged in direct solicitation activity in the U.S., as distinct from quotes disseminated through TOPIC. It also did not apply to a SEAQ market maker providing analytic or research reports to U.S. investors through TOPIC or otherwise. This temporary no-action position has been extended until December 31, 1987. See letter from Robert L.D. Colby, Chief Counsel, Division of Market Regulation, to Richard B. Smith, Davis, Polk & Wardwell, dated June 3, 1987.

Second, in August 1986, the Commission granted an exemption from broker-dealer registration to Vickers da Costa Ltd., a U.K. broker-dealer, its Tokyo branch office, and Vickers da Costa (Hong Kong) Ltd. (collectively, "Vickers Overseas"), all subsidiaries of Citicorp. At that time, another Citicorp subsidiary, Citibank, N.A., intended to acquire 80% of Vickers da Costa Securities, Inc. ("Vickers NY"), a registered U.S. broker-dealer and NASDAQ market maker. However, the Glass-Steagall Act prevented Citibank from owning Vickers NY while Vickers NY continued its business of dealing in foreign securities and ADRs. 98/ Vickers NY therefore entered into a contractual agreement with Vickers Overseas in order to maintain Vickers NY's presence as a NASDAQ market maker in foreign securities. Pursuant to this agreement, Vickers NY would execute, on a riskless principal basis, any orders received from U.S. customers against standing buy and sell orders provided by Vickers Overseas. 99/ Thus, Vickers NY's quotes in NASDAQ would always

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98/ The Glass-Steagall Act prohibits a bank from dealing in securities, and limits a bank's securities activities to those of selling securities "without recourse, solely upon the order, and for the account of, customers . . ." 12 U.S.C. 24 (1982). In addition, a bank is prohibited from association with any entity engaged in the business of "issuing, underwriting, selling or distributing . . ." securities. 12 U.S.C. 378 (1982).

99/ This arrangement was approved by the Comptroller of the Currency. See letter from Judith A. Walter, Senior Deputy Comptroller for National Operations, Comptroller of the Currency, to Ellis E. Bradford, Vice President, Citibank, N.A., dated June 13, 1986.

reflect a previously entered firm order from Vickers Overseas in order to eliminate any principal risk that might be incurred by Vickers NY. 100/

In the Vickers letter, the Commission allowed Vickers Overseas to support Vickers NY's market making activities in the manner proposed without requiring Vickers Overseas to register as a broker-dealer, but imposed conditions to add further safeguards. The Commission addressed concerns that Vickers NY would be a sham broker-dealer by eliciting a representation from Vickers Overseas that it would provide Vickers NY with weekly "not held" buy and sell orders 101/ in sufficient size to permit Vickers NY to engage in normal market making activities. Moreover, the Commission required Vickers NY to satisfy additional net capital requirements intended to ensure its ability to meet its settlement obligations even upon failure of Vickers Overseas. In addition, Citicorp represented that information regarding the trading activities of Vickers Overseas would be made available to the Commission in connection with any investigation. Further,

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100/ Letter from Jonathan Katz, Secretary, SEC, to Marcia MacHarg, Debevoise & Plimpton, dated August 13, 1986.

101/ Vickers Overseas gave Vickers NY orders to buy and to sell specified amounts of each stock in which Vickers NY was a market maker at prices determined by Vickers NY. If the price moved outside a specified range, however, Vickers Overseas reserved the right to change its orders.

Vickers Overseas agreed to limit its securities activities in the U.S. to those enumerated in the letter. Vickers Overseas was deemed to be a customer of Vickers NY, as were all of its customers, and Citicorp represented that Vickers Overseas would not engage in any business with U.S. citizens.

The ISE/NASD linkage and the Vickers arrangement are two examples of increased international broker-dealer activities. As the cross-border trading of securities increases, broker-dealers outside the U.S. increasingly will seek access to the U.S. capital markets, and, in particular, will seek to effect transactions in foreign securities with U.S. investors. As discussed, in the past, the Commission staff generally has concluded that all forms of solicitation of U.S. investors require broker-dealer registration in the U.S. However, in light of changing trading patterns, the Commission staff is considering closely the registration implications of a wide range of contacts with U.S. investors initiated by foreign broker-dealers. For instance, as discussed, the Commission staff has allowed foreign market makers to disseminate quotes in the U.S. under the aegis of the ISE while indicating that supplementing these quotes with other forms of solicitation may require broker-dealer registration for these firms. The Commission staff is considering what other contacts with U.S. investors justify requiring registration for firms disseminating quotes in the U.S. through the ISE.

The U.S. broker-dealer registration requirements also may pose significant difficulties for firms seeking to trade with U.S. investors directly from overseas. 102/ Registration is problematic for these foreign firms because their entire overseas operations would become subject to U.S. broker-dealer requirements, such as the net capital and customer protection rules, confirmation rules, recordkeeping and reporting requirements and special service of process provisions, potentially conflicting with home country practices or regulation.

The Commission staff is considering how to accommodate these concerns. In particular, the Commission staff is considering whether the overseas trading operations of foreign broker-dealers should be permitted to have minimal contacts with U.S. investors without registration if those contacts, and any resulting transactions, involve a registered U.S. broker-dealer affiliate. Under this approach, the U.S. affiliate would be responsible for the orders from U.S. customers ultimately executed with the overseas trading desk of the foreign broker-dealer. The Commission staff is considering what conditions are necessary to protect U.S. investors trading in this manner with foreign broker-dealers,

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102/ A foreign broker-dealer engaged in U.S. securities activities may register with the Commission or may create and register an American affiliate or subsidiary, as is more commonly done. However, foreign firms may wish to deal with U.S. investors from their central trading desk located overseas, because of this desk's control of minute-by-minute trading and superior contact with overseas markets.

to guard the integrity of U.S. markets, and to maintain the Commission's enforcement powers with respect to this trading activity. In the longer term, the Commission staff is weighing whether some form of reciprocal recognition of international broker-dealers might be developed with other national securities regulators.

F. U.S. Self-Regulatory Organization Initiatives

1. Market Linkages 103/

Although much of the growth in transnational trading has occurred in the international over-the-counter markets, 104/ U.S. exchanges have attempted to capture some international order flow by entering into trading linkages with foreign markets. 105/

In 1984 the Commission was asked to approve the first such trading link, between the Montreal Stock Exchange ("ME")

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103/ There also are international market links between U.S. and foreign commodity exchanges. These include: (1) the Chicago Mercantile Exchange/Singapore International Monetary Exchange link for foreign currency futures; (2) the proposed Chicago Board of Trade/London International Financial Futures Exchange link for U.S. Treasury securities futures, and (3) the gold futures link between the Commodity Exchange, Incorporated, and certain foreign markets including the Sydney Futures Exchange. It should be noted that these are not trading links, but arrangements to allow fungible contracts to trade on the linked markets and to clear through a common clearing entity. See discussion of the Philadelphia Stock Exchange ("Phlx") and ISX link, infra note 118.

104/ See Section D. supra.

105/ The intermarket surveillance and information sharing agreements covering these linkages are described separately in the following section.

and the Boston Stock Exchange ("BSE"). 106/ During the first phase of that link, ME members were able to direct marketable limit orders 107/ to the BSE floor in approximately 40 U.S.-listed Canadian stocks (or stocks trading in the U.S. pursuant to unlisted trading privileges) then currently trading in the Intermarket Trading System. 108/ Orders were transmitted to the BSE floor through electronic terminals on the ME floor and were routed to the appropriate specialist on the BSE floor for execution. In 1985, the Commission approved an expansion of the link to enable ME members to transmit orders in certain designated stocks directly to the appropriate BSE specialist, using the Montreal Stock Exchange's Registered Representative Order Routing and Execution System ("MORRE"), the ME's automated small order execution system. 109/ Also during this second phase,

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106/ See Securities Exchange Act Release No. 21449 (November 1, 1984), 49 FR 44575.

107/ Marketable limit orders are orders to buy or sell securities at the quoted offer or the bid, respectively, or better. Limit orders were not accepted during the initial phase of the link.

108/ The Intermarket Trading System ("ITS") is a computerized communications system designed to link participating market centers by routing messages between them so that participants in one market center can communicate with participants in other market centers in order to purchase or sell stock.

109/ See Securities Exchange Act Release No. 21925 (April 8, 1985), 50 FR 14480. Until modifications to the MORRE system are completed, these orders will be routed to the BSE specialist by a private data processing firm.

the BSE's execution guarantee rule, which requires BSE specialists to accept and guarantee all agency orders from 100 to 1,299 shares, was extended to apply to link trades. During both phases of the link the ME has agreed to guarantee its members' trades. From June 1985 to June 30, 1987, the six ME participants eligible to process trades through the link had completed 11,085 trades representing 5,294,865 shares.

The Commission approved the first trading linkage between a primary U.S. market and a primary foreign market in 1985. The Amex and the TSE proposed a link to permit order flow to be routed between the two exchanges in securities dually listed on the Amex and the TSE. 110/ The exchanges commenced trading in September 1985 on a pilot basis with seven dually listed securities. The number of eligible issues has increased to 17. The exchanges intend to expand this number to 34, the total number of dually listed securities.

The Amex and the TSE each displays on its trading floor the quotes distributed by the other exchange in linkage stocks. Both exchanges also display the best U.S. dollar/Canadian dollar exchange rates quoted by currency dealers on the TSE. In addition, the Amex has developed a mechanism for displaying on the Amex floor a composite quote showing the TSE price simultaneously in both U.S. and Canadian dollars. Quotes and

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110/ See order approving the link in Securities Exchange Act Release No. 22442 (September 20, 1985), 50 FR 39201.

orders are transmitted through each exchange's existing automated routing systems. As with the first stage of the BSE-ME link, only marketable limit orders are eligible for transmission through link facilities.

The Amex has provided the Commission with statistics that show relatively low link usage. Cumulatively, through June 24, 1987, 986 southbound trades have been executed on the Amex, representing 1,946,800 shares, while only 118 northbound trades have been executed on the TSE, representing 230,900 shares. The exchanges expect to expand the link in the future to include "away from the market" orders. The exchanges also anticipate that, in time, they will seek Commission approval to expand the list of eligible securities to include securities traded on either exchange and not just those that are dually listed.

The TSE also has entered into a two-way trading link with the Midwest Stock Exchange ("MSE"). The Commission approved the MSE-TSE link in 1986, initially authorizing link trading in six dually-listed stocks. 111/ Eighteen issues currently are eligible for trading through the link. The exchanges anticipate that the link will be expanded to include all MSE-TSE dually-traded securities that are also listed on the NYSE.

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111/ See Securities Exchange Act Release No. 23075 (March 28, 1986), 51 FR 11854.

Many aspects of the MSE-TSE linkage are similar to the Amex-TSE linkage. For example, only marketable limit orders currently are eligible to be processed through the link. Furthermore, marketable agency orders are guaranteed an execution at the best available quote up to a specified number of shares. Eventually, the exchanges expect to expand the link to include away from the market orders. Each exchange displays quotes from the other exchange on those stocks eligible to be traded through the linkage. The quotes the TSE receives are the national best bid and offer distributed by the Consolidated Quotation System 112/ for any linkage-traded issue that is also traded through the ITS. Quotes received by the MSE represent the best bid and offer on the TSE.

Currently, 20 MSE members use the link for northbound trades and six TSE members direct order flow south to the MSE. According to statistics provided by the MSE for 1986, 219 southbound trades were executed on the MSE representing 263,609 shares. During the same period 32 northbound trades representing 54,700 shares were executed through the link. In the first half of 1987, there were 133 southbound trades representing 225,154 shares and 13 northbound trades representing 17,600 shares.

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112/ The Consolidated Quotation System is an arrangement whereby quotations from all United States market centers (including third market makers) are made available through information vendors in a single consolidated data stream processed by the Securities Industry Automation Corporation.

In April 1986, the Commission granted approval for a six-month pilot program testing an automated linkage between the NASD and the ISE. 113/ The linkage provides for the exchange of market data between the NASD and the ISE. Specifically, the NASD's automated quotation system, NASDAQ, displays quotes for the 100 ISE stocks included in the Financial Times Stock Exchange Index and for 188 non-British stocks quoted in the ISE's new SEAQ International system. 114/ The ISE's automated quotation system, SEAQ, displays firm quotes for 200 NASDAQ companies and 70 non-British companies whose ADRs are traded through NASDAQ. Ultimately, the NASD and ISE anticipate the development of a full trading link, including automatic execution

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113/ See Securities Exchange Act Release No. 23158 (April 21, 1986), 51 FR 15989. The Commission has extended the pilot program for four consecutive time periods, the most recent of which will expire on August 31, 1987. See Securities Exchange Act Release No. 24544 (June 3, 1987), 52 FR 21781 (June 9, 1987).

The Commission has not yet granted full approval to the quote sharing arrangement. At least one commentator has objected to potential anticompetitive effects of the arrangement. The terms of the NASD-ISE agreement provide for the exchange of information between the NASD and the ISE at no charge and for the subsequent provision of that information to subscribers. Information vendors who also wish to sell this data to subscribers must purchase it from the NASD and the ISE, potentially placing those vendors at a competitive disadvantage.

114/ See supra note 61.

capability. 115/ The NASD also is negotiating a three-way agreement with the Singapore Stock Exchange and the ISE to provide for 24-hour quote dissemination.

In addition to the already approved market linkages discussed above, the Amex intends to enter into a licensing agreement with the European Options Exchange ("EOE") to enable the EOE to provide trading facilities for options contracts on the Major Market Index ("XMI"), 116/ which would be fully fungible with XMI options contracts traded on the Amex. 117/ The Options Clearing Corporation ("OCC") also is conducting negotiations with the EOE to establish mechanisms for the issuance, clearance and settlement of these options. The Amex and the OCC have formally submitted proposals to the Commission seeking approval of these agreements. 118/

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115/ Because the linkage is limited to the exchange of quotation information at this time, it is of limited value to professional market participants who already receive the information from a number of information sources, according to James M. Davin, NASD Board of Governors. Mr. Davin believes that the information may be useful to institutional investors. See Summary of Internationalization Roundtable, attached as Appendix B.

116/ The XMI is a 20-stock index that correlates closely, at a 1 to 5 ratio, with the Dow Jones Industrial Average.

117/ The arrangement contemplated by the Amex and EOE is not a communications or trading link, but rather a plan under which the EOE would list and trade XMI options contracts identical to those listed and traded on the Amex.

118/ See Securities Exchange Act Release Nos. 24462 (May 15, 1987), 52 FR 19942 (May 20, 1987) and 24404 (April 29, 1987), 52 FR 16469 (May 5, 1987). The Phlx and the OCC also were negotiating a similar arrangement with the ISE

In reviewing proposed trading linkages, the Commission has focused on several issues. The most crucial element in these linkages has been whether adequate provision is made for the sharing of enforcement and surveillance information. The Commission also has considered whether the home country of the linked market has enacted any type of "blocking statute" (legislation that prohibits the provision of information to foreigners under certain conditions). 119/ Finally, the Commission takes into account any inter-governmental information sharing agreements between the Commission and the foreign sovereign with jurisdiction over the linked market. These arrangements are discussed in greater detail in the following section.

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(continued footnote)

and the International Commodity Clearing House for the foreign currency options traded on the Phlx, but the Phlx has indicated that it does not expect to pursue those negotiations at this time. In addition, the Commission approved an agreement between the International Futures Exchange (Bermuda) Ltd. ("Intex") and the Pacific Stock Exchange ("PSE"), that allows the simultaneous trading on the PSE and the Intex of futures and options, respectively, on the Financial News Composite Index. The Intex is a computerized marketplace in which quotes are entered and executions take place within the computerized system. Under this arrangement, Intex and PSE members have electronic access to each others' futures and options markets. See Securities Exchange Act Release No. 23795 (November 12, 1986), 51 FR 41884.

119/ See infra Section F.2. for a discussion of intermarket enforcement and surveillance sharing agreements and blocking statute concerns.

In addition to considering the adequacy of the information sharing mechanisms, the Commission has insisted that any exchange seeking to link with a U.S. exchange has the ability to discipline its members for violations of its rules governing trades sent by its members through the linkage for execution. Finally, the Commission has examined proposed linkages to determine whether the markets seeking a trading link have similar, or at least do not have conflicting, rules and regulatory structures. The linkages the Commission has thus far approved have involved foreign markets with antifraud laws and investor protection rules similar to those in the U.S. In addition, all of the trading linkages contain provisions protecting exchange members' quotes to a certain degree by providing that market makers from each exchange will be able to have their U.S. dollar quotes displayed on the floor of the other exchange and that the market maker for the stock on the exchange receiving the quotation will use its best efforts to see that no trade is effected on the exchange at a price inferior to that displayed.

## 2. Intermarket Information Sharing Agreements

One of the major challenges posed by the internationalization of the securities markets is the detection and prosecution of transnational fraudulent activity. Because intermarket linkages increase the integration of trading in U.S. and foreign markets, the Commission has taken the position that approval should be conditioned on the development of routine surveillance and

information sharing agreements among the linked markets. The Commission has also looked for assurances that there are no barriers to the exchange of investigatory information between the relevant foreign regulatory body and the Commission.

(a) Amex and Toronto Stock Exchange

The trades in the Amex-TSE linkage are subject to the routine market surveillance procedure of the exchanges. 120/ There is routine exchange of information between the exchanges, including market surveillance reports and other data essential to the exchanges' surveillance programs relating to the linkage. Additional information is exchanged upon "reasonable request." In investigations of linkage transactions the exchanges have agreed to "cooperate fully" and use their "best efforts" to obtain information from their members. The market surveillance information exchanged remains confidential except to the extent that its disclosure is required for a regulatory proceeding by an exchange or by either the Commission or the Ontario Securities Commission ("OSC").

In connection with this linkage, the Commission was concerned about the Canadian blocking statute, 121/ which enables Canadian officials to limit the information and documents provided to

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120/ The TSE's surveillance capabilities are comparable to those of the U.S. exchanges.

121/ Foreign Extraterritorial Measures Act, Stat. Can., c. 49. See Securities Exchange Act Release No. 22442 (September 20, 1985), 50 FR 39201.

other countries under certain circumstances. The Commission sought and received assurances that: (1) the linkage agreement itself contained adequate information sharing provisions; (2) open channels of communications would be maintained and information and investigative resources would be shared with the OSC; and (3) the Canadian government would be unlikely to use the blocking statute in light of the similarity of the countries' regulatory schemes and customer protection objectives. 122/

(b) The NASD and International Stock Exchange for the United Kingdom and the Republic of Ireland

The NASD-ISE information sharing agreement provides that the NASD will have access to all the regulatory information it needs for purposes of its surveillance and investigation responsibilities concerning securities in the pilot program. The NASD indicates that for several years the ISE has been willing to cooperate with the NASD in the areas of information disclosure, quotation and trading halts, suspensions and resumptions of trading, and the surveillance and investigation

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122/ Letter from Tory, Tory, DesLauriers & Binnington, to Huntley W.F. McKay, Vice President, TSE, dated June 18, 1985; letter from Richard G. Ketchum, Director, Division of Market Regulation, and Gary Lynch, Director, Division of Enforcement, SEC, to Ermanno Pascutto, Director, TSE, dated September 24, 1985; letter from Ermanno Pascutto to Richard G. Ketchum and Gary Lynch, dated September 24, 1985. The information sharing agreements arising from the MSE-TSE linkage are similar and were accompanied by a similar exchange of letters. See letter from Richard G. Ketchum and Gary Lynch to Ermanno Pascutto, dated March 28, 1986; letter from Ermanno Pascutto to Richard G. Ketchum and Gary Lynch, dated May 28, 1986.

of trading in securities of mutual market concern. 123/ The NASD-ISE agreement specifically confirms that the Commission and the United Kingdom will have access to shared surveillance information.

On September 23, 1986, the Commission and the Commodity Futures Trading Commission executed a Memorandum of Understanding on the Exchange of Information with the United Kingdom Department of Trade and Industry ("DTI"). 124/ This agreement is intended to facilitate the sharing of information needed by the parties to enforce their respective laws. It also has created a cooperative environment where both the Commission and the DTI have committed to facilitate the exchange of surveillance information necessary to support the NASD-ISE pilot program. The agreement sets forth standards with which any request for information must comply, the purposes for which the information may be sought (generally, to secure enforcement of applicable laws, rules and regulations), and the confidential nature of any information received under the agreement. 125/

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123/ See File No. SR-NASD-86-4, Securities Exchange Act Release No. 23158 (April 21, 1986), 51 FR 15989 (April 29, 1986).

124/ This Memorandum of Understanding is discussed in detail infra in Chapter VII of this Study.

125/ As indicated above, supra note 118, the Intex and the PSE have entered into an agreement for the simultaneous trading on the PSE and the Intex of options and futures based on the Financial News Composite Index ("FNCI"). Under Intex's trading regulations, Intex will be authorized to provide information to the PSE, provided that the PSE keeps the information confidential, the PSE uses the information

### 3. International Clearance and Settlement

Market participants consider the need for improved international clearance and settlement to be the critical issue if internationalization of the world's securities markets is to continue. <sup>126/</sup> Problems in this area fall into two broad categories: (1) the lack of international clearance and settlement links to facilitate cross-border settlements; and (2) the existence of widely varying clearance and settlement systems among the world's capital markets.

U.S. clearing agencies have taken a strong lead in forging numerous links with their foreign counterparts and addressing international clearance and settlement issues. The Commission's staff has overseen and facilitated those efforts, on a case-by-case basis, among other ways, through "no-action" letters.

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(continued footnote)

solely for surveillance and other regulatory purposes, and Intex's trading member is notified of the PSE's request before Intex transmits the request to the requesting exchange. The PSE also will be obligated to provide Intex information on mutual members as needed by Intex to fulfill its own surveillance and self-regulatory responsibilities concerning trading of FNCI contracts. The Bermuda Minister of Finance has stated that he favors the agreement between the PSE and the Intex for regulatory surveillance and assured the PSE that he foresaw no circumstances that would warrant invocation of Bermuda's Protection of Trading Interest Act of 1981 to frustrate the surveillance sharing agreement between the PSE and Intex. Letter from Mansfield H. Brock, Jr., Financial Secretary for Ministry of Finance, to Pacific Stock Exchange, dated October 20, 1986.

<sup>126/</sup> See, e.g., Internationalization Roundtable Summary, Appendix B.

(a) Clearance and Settlement Linkages

The establishment of automated clearance and settlement linkages has been critical to the development of the internationalization of the securities markets. Absent established international systems, broker-dealers and their institutional customers often are forced to devote substantial resources to each task related to trade settlement and must effect securities deliveries by physical means, on a trade-by-trade basis.

Prompt and effective communications are essential. Generally, settlement-related information is communicated by telex, telephone, facsimile or mail. Cash and securities are exchanged via transatlantic courier transportation on a transaction-by-transaction basis. The parties to the trade must be sure that no dispute exists concerning the terms of the trade (e.g., security, price, quantity); securities and cash must be readied for delivery and payment; and transfers of securities and cash must be accomplished. If the trade is executed on an agency basis for a customer who engaged an investment manager to make investment decisions and a custodian bank to hold the investment portfolio, extensive communication among these entities (the broker, bank and investment manager) will be necessary before the bank will release funds or securities to the broker (against delivery of securities or payment of funds) on the agreed settlement date.

This physical mode of processing transaction settlements often subjects the parties to costly delays and increased risk

of loss and theft. As demonstrated by the U.S. securities industry in the late 1960s, 127/ settling transactions one-by-one with slow, decentralized communication and delivery facilities taxes the back-office processing capabilities of broker-dealers enormously during high volume trading periods, resulting in increased costs and risks of operational and financial failure. In contrast, the potential benefits of international clearance and settlement links include: centralized communication facilities; automated data processing; immobilization of securities certificates; and, through future enhancements such as netting, reduced money and securities transfers.

Given these advantages, industry participants have agreed on the importance of a viable international clearance and settlement system in minimizing transaction costs and accommodating high-volume trading. What the nature and scope of that "international system" should be, however, remain at issue. To date, the focus has been on the development of linkages among national clearing systems, although increased emphasis also has been placed on achieving greater uniformity within the various clearing systems. 128/

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127/ See Securities Exchange Act Release No. 13163 (January 13, 1977), 42 FR 3916 (January 21, 1977) (National Securities Clearing Corporation ("NSCC") temporary registration order); Securities and Exchange Commission, "Study of Unsafe and Unsound Practices of Brokers and Dealers", H.R. Doc. No. 231, 92nd Cong., 1st Sess. 13 (1971).

128/ See discussion, infra Section F.3.(c) Uniformity of Clearance and Settlement Systems.

Since 1980, several U.S. registered clearing agencies have pursued clearance and settlement linkages with their foreign counterparts. As described below, these links, until recently, have involved access to U.S. clearing agency services by non-U.S. clearing systems on behalf of their members. Recent efforts, however, have focused on U.S. clearing agencies access on behalf of their members to non-U.S. clearing systems.

(1) Foreign Clearing System Access to or Use of U.S. Clearing Agency Facilities

The majority of the linkages developed to date have been one-way arrangements, which provide non-U.S. broker-dealers and institutional customers with indirect access to U.S. clearing agencies through their domestic clearing entity. Generally, under these agreements the non-U.S. clearing entity either becomes a full member of the U.S. clearing agency, or agrees to be bound, as if it were a member, to most of the U.S. clearing agency's rules, including financial standards and safeguards. The foreign clearing entity effectively "sponsors" its members into the U.S. clearing agency, carrying their accounts and guaranteeing to the U.S. clearing agency the performance of its members' settlement obligations.

The first linkage between U.S. and foreign clearing entities entailed limited, indirect access to the Depository Trust Company ("DTC") through Bankers Trust Company ("BTC"). In 1980, BTC entered into an agreement with the Nominee Amsterdam Stock

Exchange N.V. ("NASE") to provide NASE participants with indirect access to DTC custodial services. The arrangement permitted BTC to maintain securities deposits at DTC on behalf of the NASE and to perform custodial services on behalf of the NASE (such as deposits and withdrawals) in U.S. securities issues traded on the Amsterdam Stock Exchange. 129/

The second arrangement reviewed by the Commission staff involved an agreement between Trans Canada Options, Inc. ("TCO"), the National Securities Clearing Corporation ("NSCC") and the OCC. The arrangement was designed to facilitate U.S. investor access to Canadian securities options markets by providing a convenient mechanism for U.S. investors to settle options transactions in Canadian securities executed on Canadian exchanges. The NSCC and the OCC act as agents for TCO by performing trade reporting and settlement functions in the U.S. and facilitating access by U.S. broker-dealers to foreign markets. TCO did not become a member of the NSCC or the OCC under this arrangement. 130/

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129/ See letter from Jerry R. Marlatt, Staff Attorney, Division of Market Regulation, to Alan H. Paley, Debevoise, Plimpton, Lyons & Gates, dated July 25, 1980.

130/ See letter from Dan W. Schneider, Assistant Director, Division of Market Regulation, to Andrew M. Klein, Schiff, Hardin & Waite, dated March 25, 1982; letter from Richard G. Ketchum, Associate Director, Division of Market Regulation, to Robert J. Woldow, Vice President and General Counsel, NSCC, dated August 18, 1982.

In 1984, the NSCC established the first international linkage in which a foreign clearing entity, the Canadian Depository for Securities ("CDS"), obtained direct access to a U.S. clearing agency. During 1984, the Commission staff issued "no-action" letters concerning CDS participation in NSCC to facilitate CDS members' clearance and settlement of: (1) OTC transactions in U.S. securities; 131/ (2) trades executed on the BSE through the link with the ME; 132/ and (3) trades in U.S. securities executed on the Amex or the TSE through the TSE-Amex trading link. 133/

In 1985, the Commission staff issued a "no-action" letter to the Midwest Clearing Corporation and Midwest Securities Trust Company ("MCC/MSTC") concerning their arrangement with the Vancouver Stock Exchange Services Corporation ("VSESC"). That link provides Canadian broker-dealers access to MCC/MSTC's systems, particularly the National OTC Comparison System, to

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131/ See letter from Dan W. Schneider, Deputy Associate Director, Division of Market Regulation, to Karen L. Saperstein, Assistant General Counsel, NSCC, dated October 24, 1984.

132/ See letter from Dan W. Schneider, Deputy Associate Director, Division of Market Regulation, to Karen L. Saperstein, Assistant General Counsel, NSCC, dated November 26, 1984.

133/ See letter from Jonathan Kallman, Assistant Director, Division of Market Regulation, to Karen L. Saperstein, Assistant General Counsel, NSCC, dated September 20, 1985.

clear and settle over-the-counter trades in U.S. exchange-listed securities, NASDAQ securities or Canadian-exchange listed securities. 134/ In 1986, MCC/MSTC and the CDS established a link to facilitate clearance and settlement of trades between MSE members and Canadian broker-dealers executed through the MSE-TSE trading link. 135/

MCC and MSTC were the first U.S. clearing agencies to enter into a direct linkage agreement with a European clearing entity. In 1986, MCC/MSTC accepted the ISE as a member to grant access to ISE members who wished to use MCC/MSTC facilities to clear and settle with U.S. broker-dealers their OTC trades in U.S. securities. 136/

The OCC currently is negotiating with the European Options Exchange ("EOE") to establish a link to support EOE member trades in XMI options, which are proposed to be traded on a

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134/ See letter from Jonathan Kallman, Assistant Director, Division of Market Regulation, to Michael Wise, Associate Counsel, MCC/MSTC, dated September 12, 1985.

135/ See letter from Jonathan Kallman, Assistant Director, Division of Market Regulation, to Michael Wise, Associate Counsel, MCC/MSTC, dated March 21, 1986.

136/ MCC and MSTC also have reached an agreement to establish a linkage agreement with la Societe Interprofessionelle pour la Compensation des Valeurs Mobilieres ("SICOVAM"). The Commission currently is reviewing the proposed linkage.

fully fungible basis, on the Amex and the EOE. 137/ If approved and implemented, this will mark the first time options traded on U.S. and non-U.S. exchanges will be cleared and settled in an integrated and fungible manner.

(2) U.S. Clearing Agency Participation in Foreign Clearing Organizations

In 1986, the NSCC formed a wholly owned subsidiary, the International Securities Clearing Corporation ("ISCC"), to centralize the development of international linkages. On August 1, 1986, the ISCC filed with the Commission an application to register as a clearing agency. 138/ The ISCC intends to enter into agreements with foreign institutions, such as foreign stock exchanges or clearing agencies, to permit U.S. broker-dealers to clear and settle, at those institutions, transactions executed on foreign exchanges. Foreign broker-dealers also would be able, through the ISCC's facilities, to clear and settle transactions in U.S. securities with U.S. broker-dealers.

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137/ See Securities Exchange Act Release No. 24404 (April 29, 1987), 52 FR 16469. See also supra Section F.1. As indicated above, supra note 118, OCC also had been negotiating an agreement with the International Commodity Clearing House Limited ("ICCH") that would have provided for clearance and settlement of the fungible foreign currency options that were to be traded on the Phlx and the ISE in accordance with proposed Phlx-ISE negotiations. The Phlx is no longer actively pursuing those negotiations.

138/ See Securities Exchange Release No. 23514 (August 6, 1986), 51 FR 29184.

In 1986, the Commission's staff issued a no-action letter on a linkage agreement providing U.S. broker-dealers entry into a foreign clearing system (i.e., "outbound" linkage). 139/ The ISCC and the ISE have established clearance and settlement facilities that enable U.S. broker-dealers to clear and settle trades in securities traded on the ISE through ISE facilities. The agreements provide that the ISE will sponsor its members into the ISE, guaranteeing its members' performance of settlement obligations. 140/ The Commission staff's no-action position allows a pilot program to test the operation of the link. 141/

Other outbound linkages, similar to that developed by the ISCC and ISE, have not developed, in part, because of some uncertainty under the Uniform Commercial Code ("UCC"). The UCC establishes, among other things, when and how delivery of securities occurs. The UCC, as adopted in most states, appears to require clearing agencies to maintain certificates in their vaults, in the custody of a U.S.-registered clearing agency, or in a bank subject to examination by U.S. federal or state bank

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139/ See letters from Jonathan Kallman, Assistant Director, Division of Market Regulation, to Karen L. Saperstein, Assistant General Counsel, ISCC, dated October 10, 1986 and December 10, 1986.

140/ Id.

141/ The ISCC also requested a no-action position on an "in-bound" linkage with ISE (i.e., enabling United Kingdom brokerdealers to clear and settle trades in U.S. securities through U.S. clearing agency facilities). The ISCC and the ISE are still negotiating the terms of that linkage.

regulatory agencies. By its terms, the UCC does not expressly recognize subcustodial arrangements that U.S. clearing agencies may have with foreign entities. In 1985, Illinois enacted amendments to its UCC Article 8, validating deliveries on the books of a registered clearing agency that maintains certificates with a foreign clearing agency under arrangements permitted by the Commission. This amendment represents a significant step toward safe and efficient processing of international securities transactions through two-way interfaces between domestic clearing agencies and their foreign counterparts. Similar changes to New York, Pennsylvania and Delaware law might be one way to facilitate arrangements between foreign custodians and U.S. clearing agencies domiciled or organized under the laws of those states. The Commission has encouraged clearing agencies to pursue such amendments to state laws affecting their proposed international arrangements. 142/

(b) Direct Foreign Broker-Dealer and Bank  
Membership in U.S. Clearing Agencies

One alternative to physical international settlement or settlement through linkages is direct participation in a foreign clearing entity. In 1985, the Commission approved an OCC rule change that enables foreign securities firms to join the OCC as

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142/ See Securities Exchange Act Release No. 23568 (August 28, 1986), 51 FR 31863.

full members and subjects them to substantially the same requirements as U.S. firms. 143/ OCC sought approval to accept financial reports from Canadian members in accordance with Canadian, rather than U.S., accounting standards. 144/ MCC and MSTC also have accepted three foreign securities firms as members, subject to all of the same membership requirements as U.S. broker-dealers.

(c) Uniformity of Clearance and Settlement Systems

The arrangements described above offer the advantage of granting to foreign market participants access to domestic clearance and settlement systems. Although these arrangements provide substantially improved mechanisms for clearance and settlement of international trades, they do not address the problem of coordinating settlements among foreign clearing entities with widely differing settlement cycles, system capabilities, or financial responsibility and operational standards.

Settlement time frames vary widely among international market centers -- from five days in New York to one month in

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143/ See Securities Exchange Release No. 22123 (June 6, 1985), 50 FR 24853.

144/ See Securities Exchange Act Release No. 23487 (July 31, 1986), 51 FR 28466 (Notice of the proposal).

France. 145/ For example, U.S. broker-dealer members of ISCC who use the ISCC-ISE link must coordinate U.S. trade settlements with those in ISE's Talisman system, which typically requires trades executed during a two-week "dealing" period to settle delivery and payment obligations on the second Monday after the close of the dealing period. 146/ In contrast, broker-dealers' U.S. trades settle, generally, five days after the trade date.

U.S. market participants often must contend with coordinating settlements in highly automated markets such as the U.S. and Hong Kong with settlements in markets such as Japan and Italy,

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145/ Recognizing the significant differences in settlement procedures and time frames, the ISCC sought and received an opinion letter from the Board of Governors of the Federal Reserve System ("Board") interpreting the application of Regulation T to U.S. broker-dealers' foreign securities trades. Specifically, the Board stated that Regulation T may be relied upon to permit a broker-dealer to receive payment from a customer in a delivery against payment transaction involving United Kingdom or French securities on a date later than 7 business days after trade date if the delay is due to the mechanics of the settlement procedures in those countries. See letter from Laura Homer, Securities Credit Officer, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, to Karen L. Saperstein, Assistant General Counsel, ISCC, dated July 8, 1986.

146/ Other settlement cycles average as follows: (1) Australia -- 5 to 10 days; (2) Belgium -- 2 business days; (3) France -- fixed monthly settlement date; (4) Italy -- 3-44 days (because of the 40% fail rate, however, deliveries often take months); (5) Luxembourg -- 5 business days for stocks and 7 business days for bonds; (6) Spain -- 0-3 days for purchases and 110 days for sales.

where clearance and settlement is largely handled physically. Furthermore, trades cleared and settled through U.S. clearing agency facilities are processed in a continuous net settlement system, 147/ while most other clearing systems are delivery versus payment systems 148/ or require their members to settle trades on a trade-for-trade basis. 149/

The growing internationalization of the world's capital markets is introducing new risks to national clearance and settlement systems. Because of the different types of guarantees associated with these settlement systems, loss allocation mechanisms and financial responsibility requirements vary among market clearing organizations. These standards, of course, were developed in the context of purely domestic clearance and settlement activity. Thus, in developing international clearing arrangements, it may be necessary to reexamine member financial responsibility standards in light of clearing systems' increased exposure from international obligations.

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147/ A continuous net settlement system is one in which the clearing system nets its members' trades and interposes itself between the original parties to a trade. Settlement is with the clearing agency, which guarantees the trade to each of the parties. See supra note 44.

148/ Delivery versus payment systems do not provide a netting system for participants.

149/ Trade-for-trade settlement systems generally do not provide participants guarantees of their securities trades. Participants may use the clearing system for comparison of their trades and delivery but the clearing system's role remains that of an agent to the parties.

Although the development of international clearance and settlement links is clearly a step forward for international securities markets, the lack of uniform clearance and settlement standards still must be addressed. Several multinational organizations are attempting to create uniform or, alternatively, compatible standards and procedures for clearance and settlement systems. 150/ Recently, the International Organization of Securities Commissioners ("IOSC") established a subcommittee on clearance and settlement that is expected to begin discussing many of the problems outlined above at the next annual meeting in September 1987.

4. Exchange and NASDAQ Foreign Issuer Listing Requirements

On June 11, 1987, the Commission approved rule proposals submitted by the Amex and NYSE to enable the exchanges to waive or modify certain corporate governance and financial disclosure listing standards for foreign companies. 151/ Specifically, the

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150/ Industry groups include the International Society of Securities Administrators, the International Federation of Stock Exchanges and the International Operations Association.

151/ Securities Exchange Act Release No. 24634 (June 23, 1987), 52 FR 24230. These proposals did not affect the Amex or NYSE quantitative (e.g., public float, assets, income) listing standards for foreign issuers. To qualify for listing on the Amex or the NYSE, foreign companies must meet either: (1) the same quantitative standards applicable to domestic companies, requiring broad share distribution in the U.S. and specifying size and earnings requirements; or (2) alternative quantitative standards, requiring broad worldwide share distribution and specifying considerably greater size and earnings requirements. Both sets of standards ensure that listed foreign companies are well-established companies whose shares are held widely either in the U.S. or worldwide, thus assuring a substantial following by securities analysts.

Amex and NYSE rule changes permit the exchanges to consider a foreign company's compliance with the laws, customs and practices of the country of its domicile in determining whether the company has complied with the otherwise applicable listing standards. An exception or waiver from exchange listing standards may be granted in any of the following areas: (1) quarterly reporting of interim earnings; (2) composition and election of the Board of Directors; (3) shareholder approval requirements and voting rights; 152/ and (4) quorum requirements for shareholder meetings. Both the Amex and the NYSE require, however, that interim earnings be reported on a semi-annual basis and earnings statements and other reports be available in English. 153/

At the same time the Commission approved an NASD proposal to establish corporate governance standards for NASDAQ/National Market System ("NMS") issuers and to provide exemptions similar to

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152/ The Commission recently instituted proceedings under Section 19(c) of the Act to consider whether to adopt a rule (proposed Rule 19c-4) regarding disenfranchisement of shareholders. See Securities Exchange Act Release No. 24623, June 22, 1987. Proposed Rule 19c-4, as currently drafted, would apply only to domestic issuers. The Commission, however, is soliciting comments on whether the proposed rule should apply to foreign issuers as well as domestic issuers.

153/ Before an exemption or waiver can be granted, the foreign company must provide an opinion from independent counsel that the practices of the issuer are consistent with the laws, customs or practices of its country of domicile.

Amex's and NYSE's for foreign issuers. 154/ The Amex, NYSE and NASD proposals resulted from concern that their requirements (proposed requirements in the case of the NASD) relating to various corporate governance procedures and interim earnings reports could unduly inhibit foreign companies from listing on the exchanges or seeking inclusion 155/ in the NASDAQ/NMS system because some listing standards are either inconsistent with or contrary to the laws, business customs or practices of the companies' home country. 156/ In approving the proposals, the Commission determined that, where the fundamental investor protections of the federal securities laws and SRO rules remain in place, it is appropriate to permit differentiations from the requirements imposed on domestic companies to permit the U.S. SROs to be more competitive on an international basis and to

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154/ Securities Exchange Act Release No. 24634 (June 23, 1987), 52 FR 24230. The approval corporate governance standards require NMS issuers to distribute reports to shareholders with the same frequency as those reports are filed with the Commission. The NASD standards also establish requirements concerning audit committees, independent directors, shareholder meetings, quorums, solicitations of proxies, and conflicts of interest.

155/ The NASD's foreign issuer waiver provision also is intended to discourage foreign issuers that came into the NMS system before the adoption of the NASD's new NMS corporate governance standards, supra note 154, from leaving the system to avoid compliance with these standards where they may be inconsistent with the issuers' home country law or practice.

156/ For example, many Scandinavian companies are required to afford significant board level representation to their employees, which may be in conflict with Amex requirements relating to voting for corporate boards.

provide U.S. investors with investment opportunities in a larger number of foreign securities. 157/

G. Application of Rules 10b-6 and 10b-7 to Multinational Offerings

Rules governing secondary market trading activity during an offering also are implicated by the internationalization of the securities market. In particular, Rules 10b-6 and 10b-7 under the Securities Exchange Act 158/ create issues for foreign companies registering offerings in the U.S. because foreign methods of distributing securities often differ substantially from those utilized in the U.S.

Rule 10b-6 proscribes certain conduct by persons who are participating in a distribution. The purpose of the Commission rule is to prevent persons who are participating in a distribution from artificially conditioning the market for the securities in order to facilitate the distribution. The rule achieves this antimanipulative goal by prohibiting, subject to certain exceptions, persons engaged in a distribution of securities from bidding for or purchasing, or inducing others to bid for or purchase, such securities, any security of the same class and

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157/ In this connection, in its order approving the NYSE and Amex proposals, the Commission noted that currently U.S. members interested in purchasing foreign issues can execute their orders in a foreign market that may offer less protection to investors than those provided in U.S. markets. Accordingly, in the Commission's view, permitting a number of foreign securities to be traded on U.S. regulated exchange markets may actually increase protection for U.S. investors.

158/ 17 C.F.R. 240.10b-6 and -7.

series as those securities, or any right to purchase any such security, from a specified period (2 or 9 business days) prior to commencement of offers and sales in the distribution, until they have completed their participation in the distribution.

The issues raised may be best illustrated by examples of distribution practices in two countries with issuers that have recently raised capital in the U.S., Great Britain and France. In British practice, the underwriters offer investment advice to their clients throughout the offering period. To the extent such advice constitutes an "inducement to bid for or purchase," Rule 10b-6 would be violated. Further, the subunderwriters (essentially, institutional investors) may trade for their own account throughout the distribution. This also could constitute a Rule 10b-6 violation.

In France, transactions generally take place through an agent de change (roughly comparable to a stock exchange specialist in the U.S., although the agent de change cannot take a proprietary position in securities). It is customary for the sponsoring bank (or the issuer) to assist the agent de change for a period of time following a public offering in maintaining an orderly market. <sup>159/</sup> For the issuer or an entity affiliated with an underwriter in the U.S. distribution, this activity would be prohibited by Rule 10b-6.

Rule 10b-7 governs stabilization of the price of a security to facilitate an offering. In the multinational

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<sup>159/</sup> See infra note 164.

offering context, the primary application of Rule 10b-7 is the requirement regarding the relationship between the level of any stabilizing bid in a secondary market and the price at which the security is stabilized in its primary market. Further, Rule 10b-7 does not permit a stabilizing bid to be increased. In conjunction, these provisions of Rule 10b-7 may present difficulties resulting from a change in currency exchange rates in the markets where stabilization is conducted.

In 1977, British Petroleum ("BP") offered securities in the United Kingdom and the U.S. The Commission staff issued a letter granting an exemption to the British underwriters to permit them to induce purchases of BP securities (offering investment advice to their clients involving the purchase of BP securities otherwise than in the distribution) if, among other things, such inducements were:

1. In the ordinary course of business;
2. Not for the purpose of creating actual or apparent trading;
3. Not for the purpose of raising the price of any BP security; and
4. Otherwise in compliance with Rule 10b-6. 160/

These restrictions applied until the completion of the distribution in the U.S. The staff took a no-action position without imposing any conditions to allow the British sub-underwriters to continue to trade during the distribution.

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160/ See letter regarding The British Petroleum Company Limited (June 14, 1977).

Commission staff also provided exemptive and no-action relief regarding subsequent BP offerings. In 1979, BP offered shares to the public in the United Kingdom; however, nationals of other countries could participate if they met certain qualifications. Any such persons would have to apply for the ordinary shares in Britain in the same manner as if they had been British nationals. There was no U.S. underwriting or dealer group. The staff issued a letter granting relief subject to substantially the same conditions as those imposed in 1977. The principal area of difference was the addition of a condition to the relief granted to the underwriters that transactions resulting from any inducements to purchase be "within the range independently established in the market of independent bid and asked prices prevailing in the relevant market at the time for quantities of the relevant size." 161/

BP offered shares by means of a rights offering in 1981. The offering was made to all BP shareholders, including U.S. holders of ADRs. The staff's letter granting relief was conditioned upon the fact that the British underwriters and subunderwriters agreed not to purchase or sell in the U.S., for delivery therein, any existing or new BP shares, ADRs, or

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161/ See letter regarding The British Petroleum Company Limited (October 31, 1979).

rights to subscribe therefor, other than pursuant to unsolicited orders on a U.S. national securities exchange. This undertaking was included as part of the underwriting agreement. 162/

Exemptive relief from Rule 10b-6 was also granted with respect to offerings of the securities of two French issuers, Louis Vuitton S.A. ("Vuitton") and Rhone-Poulenc S.A. ("Rhone-Poulenc"). In the Vuitton offering, an exemption was granted to allow Banque Paribas, the sponsoring bank (essentially, the underwriter) for the offering of ordinary shares on the Paris Bourse (Stock Exchange) until two business days before the commencement of offers and sales of the ADRs in the U.S. 163/ The exemption was premised on the staff's recognition of the fact that the transactions for which relief was granted were permitted under French law and would be made only at the request of an independent third party (the agent de change) 164/ at prices and in quantities determined by the

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162/ See letter regarding The British Petroleum Company Limited (July 2, 1981). In 1983, BP again offered shares to the public in the United Kingdom as in its 1979 offering. The staff issued a no-action letter on the same basis as its 1979 letter. See letter regarding The British Petroleum Company PLC (Sept. 15, 1983).

163/ See letter regarding Louis Vuitton S.A. (June 21, 1984).

164/ The agent de change is a ministerial government officer, and is somewhat equivalent to a specialist on a U.S. securities exchange except that the agent de change may not trade for its own account. The price of a security on the Paris Bourse may not vary from the prior day's close by more than 4 percent. The inability to trade for its own account is a hindrance to the agent de change

agent de change. The U.S. portion was approximately 20 percent of the total offering and was to be sold approximately two weeks after the French portion was sold. The Vuitton ordinary shares would trade on the Paris Bourse during the two week period.

The Commission staff also granted a conditional exemption from Rule 10b-6 in connection with a large offering in France and the U.S. by Rhone-Poulenc. 165/ The U.S. portion of the offering was approximately 20 percent and was to occur concurrently with the French portion of the offering. The exemption was conditioned upon the observance of a nine-day "cooling-off period" by the distribution participants and their "affiliated purchasers." 166/

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(footnote continued)

if it appears that an order imbalance is going to result in the 4 percent limit being breached, since the agent de change wishes to maintain an orderly market by avoiding a cessation of trading. In French practice, the sponsoring bank aids the agent de change in this task. Certain of the proceeds of the offering are retained by the sponsoring bank in a special account rather than distributed to the issuer or selling shareholders. This account is also frequently supplemented by the deposit of additional shares by the issuer or selling shareholders. At the request of the agent de change, the sponsoring bank may, but is not required to, trade from this account. The agent de change approaches the sponsoring bank only when an order imbalance exists.

165/ See letter regarding Rhone-Poulenc S.A. (March 13, 1987).

166/ The term "affiliated purchaser" is defined in Rule 10b-6(c)(6) to include persons acting in concert with the issuer, persons controlling the issuer's purchases or whose purchases are controlled by the issuer, and affiliated broker-dealers.

(footnote continued)

A number of recent multinational offerings involving the "privatization" program of the British Government have been conducted subject to essentially the same underwriting conditions contained in the 1979 and 1983 BP letters. 167/ The staff did not issue any letters in connection with these offerings. Rather, the conditions designed to achieve compliance with Rule 10b-6 by the non-U.S. underwriters were contractually imposed by the Orderly Marketing Agreement (essentially an agreement among underwriting syndicates). One such agreement 168/ provides, for example:

Pending the completion of the U.S. Offering:

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- (7) (a) each of the U.S. Underwriters shall comply fully with the requirements of Rule 10b-6 under the United States Securities Exchange Act of 1934 ("the 1934 Act");
- (b) for the purpose of complying with the said Rule 10b-6, none of the other Underwriters shall bid or purchase

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(continued footnote)

The French underwriters were able to accommodate the nine-day period without difficulty since trading in Rhone-Poulenc securities was suspended on the Paris Bourse for an 18-day period immediately prior to the commencement of the U.S. portion of the distribution.

167/ See British Airways, PLC, Reg. No. 33-11195 (February 11, 1987); British Gas, PLC, Reg. No. 33-9888 (December 8, 1986); British Telecommunications, PLC, Reg. No. 2-94003 (December 3, 1984).

168/ British Airways, PLC, Reg. No. 33-11195 (February 11, 1987).

. . . any Ordinary Shares or ADRs for any account in which it has a beneficial interest or (otherwise than in the ordinary course of business) attempt to induce any person to purchase . . . any Ordinary Shares of ADRs other than purchases from it;

- (c) each Underwriter recommending or effecting transactions on behalf of clients in the ordinary course of business (as referred to in Clause 7(b)) shall execute such transactions only within the range of prices independently established in the market at the time for quantities of Ordinary Shares or ADRs of the relevant size, and not for the purpose of creating actual or apparent trading in, or raising the price of, any such securities; and
- (d) in order to ensure compliance with Rules 10b-6, 10b-7 and 17a-2 under the 1934 Act [and applicable provisions of the Securities and Exchange Law of Japan], all stabilization activities, if any, on behalf of any of the Underwriters shall be conducted only with the prior consent of [the U.K. and U.S. managing underwriters]. . . .

Most recently, the Commission staff granted a Rule 10b-6 exemption to permit the underwriters of C.H. Beazer (Holdings) PLC ("Beazer") securities to continue their market making activities until two days prior to the commencement of a public offering of Beazer securities in the U.S., even though the Beazer shares trade below \$5.00 per share in the United

Kingdom. 169/ The exemption was based on the very significant market capitalization of Beazer, the large number of market-makers in Beazer shares, and the substantial trading volume of Beazer shares during the prior calendar quarter.

Relief also has been provided regarding the application of Rule 10b-7 in order to reflect the realities of international offerings. For example, the Commission recently issued two exemptive orders in global offerings to permit stabilizing bids to be placed in markets abroad and in U.S. markets based on the principal market for such securities where the principal market was not in the U.S. 170/ Staff no-action letters have provided that, under certain terms and conditions, stabilizing bids may be adjusted to reflect changes in currency relationships. 171/

H. The Commission's Global Trading Release and Internationalization Roundtable

In recognition of the accelerating movement towards global trading markets for certain securities and the increasing flow of investments across national borders, the Commission,

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169/ Rule 10b-6 permits an underwriter to continue market making until two business days before offers or sales of the security being distributed, if the stock trades at \$5.00 or more per share and has a public float of 400,000 shares, or for all other securities, until nine business days before offers or sales.

170/ Phillips N.V., Securities Exchange Act Release No. 24486 (May 12, 1987); Barclays PLC, Securities Exchange Act Release No. 24487 (May 19, 1987).

171/ See, e.g., letter regarding Banco Central, S.A. (June 30, 1987).

in April 1985, issued a release requesting comment on a broad range of issues concerning the internationalization of the securities markets. 172/ To encourage consideration of ways of attaining the fairest and most efficient global secondary markets, the Commission solicited comment on what conditions and structures should characterize international trading markets and the comparison, clearance and settlement of resulting international trades.

In January 1986, the Commission released a staff summary of the 30 comments received in response to the Global Trading Release. 173/ In brief, commentators viewed the tendency for securities to be traded outside their market of origin and for investors to seek investment opportunities in foreign securities or markets as a positive development. They also stated their belief that global trading markets would continue to grow in size and importance, but differed on whether trading through linked exchanges or an upstairs dealer network would predominate. Commentators also recognized that the Commission has an important role to play in the internationalization process, but generally cautioned that international trading markets should be allowed to develop further on their own without extensive involvement of the Commission at this point. Commentators did indicate, however, that the facilitation of intermarket trading linkages

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172/ See supra note 2.

173/ The summary is attached as Appendix A.

and international clearance and settlement facilities was an appropriate area for Commission action. Commentators also suggested that the Commission might play a useful role in encouraging agreement among the active trading markets regarding minimum standards for automated clearance and settlement systems.

The Commission considered the Release and comment summary at a public meeting in May 1986, and endorsed the view of commentators that it should proceed cautiously in responding to the growth of transnational trading. The Commission instructed the staff to facilitate the development of international linkages between securities markets and clearing agencies and to ensure that such linkages incorporate adequate market surveillance and information sharing arrangements. In addition, the Commission instructed the staff to discuss with the NASD expanding the scope of NASD after-hours trade reporting requirements. 174/ The Commission also directed the staff to continue discussing with securities markets and market participants issues of concern in the internationalization area, and to organize a roundtable on the internationalization of the securities markets.

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174/ Market and clearing linkages and the Roundtable are discussed supra. The NASD recently has expanded the scope of its after-hours reporting by requiring that reports of trades executed between 4:00 p.m. and 5:00 p.m. EST be submitted to the NASD by 5:00 p.m., rather than reported manually by the end of the week. See Securities Exchange Act Release No. 24512 (May 26, 1987), 52 FR 20656. Trades executed after 5:00 p.m. EST, however, continue to be reported to the NASD weekly on Form T.

On February 17, 1987, the Commission conducted a Roundtable Discussion on Internationalization. A summary of those proceedings is attached as Appendix B to this chapter. The Roundtable participants included experts on many different aspects of internationalization and their remarks confirmed the comments received on the Global Trading Release: (1) international trading markets are expanding and are largely institutional, although home country markets will remain the primary and most liquid markets, particularly for equities; (2) the Commission should not impose regulatory solutions but should facilitate appropriate developments in the market; (3) international clearance and settlement is the largest single problem in this area; and (4) information and surveillance sharing among regulators and markets is crucial.

CHAPTER V

APPENDIX A

## Executive Summary

In its April 1985 Global Trading Release ("Release"), the Commission solicited comment on a broad range of issues concerning the increasing internationalization of the world's securities markets. The Release requested comment on what conditions and structures should characterize international trading markets, possibly including international consolidated reporting, consolidated quotations, and intermarket linkages.

In response to the Release, the Commission received thirty letters from commentators from six countries. Commentators viewed the increasing tendency for securities to be traded outside their market of origin and for investors to seek investment opportunities in foreign securities or markets as a positive development. They also believed that global trading markets would continue to grow in size and importance. Commentators recognized that the Commission has an important role to play in the internationalization process, but generally opined that the Commission should refrain from premature action in this area, permitting international trading markets to develop further on their own.

Commentators indicated that market professionals and international investors do the majority of international trading, and will continue to dominate the global markets. Commentators also indicated that trading in those markets generally occurs on an upstairs in-house basis, and involves foreign stocks more frequently than U.S. equities.

While commentators agreed that transnational trading would increase, they differed in their views of what would constitute the future structure of the international securities markets. Several exchanges predicted that future global trading of world class securities would occur around-the-clock through a network of interconnected exchanges, while other commentators asserted that around-the-clock in-house trading by U.S.-based or large foreign securities firms was more probable. Despite differing perspectives, commentators believed that increased dissemination of quotation and trade information would facilitate the growth of global trading markets, although reservations were expressed about the practicability of immediately developing international consolidated quotation and transaction reporting systems. In addition, commentators supported industry development of intermarket linkages as needed.

Commentators generally agreed that efficient, safe, and accurate comparison, clearance, and settlement systems were

necessary for the growth of international trading, and strongly supported additional links between central clearing and depository organizations. Commentators generally indicated that the incremental development of links between existing institutions was preferable to trying to create a central international clearing or depository entity. Commentators further endorsed the current staff practice of determining foreign clearing agency eligibility for international linkage participation through no-action letters.

### Summary of Comments

In the Global Trading Release ("Release"), 1/ the Commission solicited comment on a broad range of issues concerning the increasing internationalization of the world's securities markets. The Release requested comment on what conditions and structures should characterize international trading markets, possibly including international consolidated reporting, consolidated quotations, and intermarket linkages. Other issues were clearance and settlement of international transactions, the effect of Exchange Act rules such as Rule 10b-6 on multinational distributions of securities, and international enforcement problems.

The Commission received thirty comment letters in response to the Release. The commentators were eight securities markets, 2/ one futures exchange, 3/ five entities involved in the clearance

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- 1/ Securities Exchange Act Release No. 21958 (April 18, 1985), 50 FR 16302.
- 2/ See Letter from Richard O. Scribner, Executive Vice President, Legal and Regulatory Affairs, American Stock Exchange, to John Wheeler, Secretary, SEC (December 13, 1985) ("Amex Comment"); Letter from Gerrit H. De Marez Oyns, Secretary General, Amsterdam Stock Exchange, to John Wheeler, Secretary, SEC (June 27, 1985) ("Amsterdam Comment"); Letter from R.L. Coppel, Executive Director, Australian Associated Stock Exchanges, to R.G. Ketchum, Director, Division of Market Regulation (August 14, 1985) ("AASE Comment"); Letter from T.G. Barker, Director-General, Panel on Take-overs and Mergers, London Stock Exchange, to Andrew E. Feldman, Attorney, Division of Market Regulation (May 16, 1985) ("London Comment"); Letter from Gordon S. Macklin, National Association of Securities Dealers, Inc., to John Wheeler, Secretary, SEC (November 4, 1984) ("NASD Comment"); Letter from Robert V. Roosa, Chairman, Advisory Committee on International Capital Markets of the New York Stock Exchange, to John Wheeler, Secretary, SEC (June 20, 1985) ("NYSE Comment"); Letter from Shoichi Suzuki, Director, General Administration Department, Tokyo Stock Exchange, to Richard G. Ketchum, Director, Division of Market Regulation (June 29, 1985) ("Tokyo Comment"); Letter from Keith E. Boast, Vice President, Member Regulation, Toronto Stock Exchange, to John Wheeler, Secretary, SEC (July 5, 1985) ("Toronto Comment").
- 3/ Letter from Thomas R. Donovan, President and Chief Executive Officer, Chicago Board of Trade, to John Wheeler, Secretary, SEC (July 1, 1985) ("CBT Comment").

and settlement of securities transactions, 4/ three pension fund managers, 5/ two banks, 6/ four associations, 7/ one

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- 4/ Letter from Ronald S. Ritchie, Chairman, The Canadian Depository for Securities Limited, to John Wheeler, Secretary, SEC (August 26, 1985) ("CDS Comment"); Letter from Angus G. Richards, Project Manager, Clearing House Settlement System Development, Joint Exchange Computers Pty. Limited, to John Wheeler, Secretary, SEC (August 6, 1985) ("Australian Clearing Comment"); Letter from Albert M. Anderson, President and Chief Operating Officer, Midwest Clearing Corporation/Midwest Securities Trust Company, to John Wheeler, Secretary, SEC (October 14, 1985) ("MCC/MSTC Comment"); Letter from Robert J. Woldow, Senior Vice President and General Counsel, National Securities Clearing Corporation, to John Wheeler, Secretary, SEC (September 30, 1985) ("NSCC Comment"); Letter from David R. Sawyer, Sidley & Austin, to John Wheeler, Secretary, SEC (December 10, 1985) (enclosing International Commodities Clearing House Limited's comment) ("ICCH Comment").
- 5/ Letter from D.A. Lyle, Executive Director, Baring International Investment Limited, to John Wheeler, Secretary, SEC (June 20, 1985) ("Baring Comment"); Letter from Roger G. Ward, Deputy Managing Director, BT Investment Management Ltd., to John Wheeler, Secretary, SEC (June 24, 1985) ("BT Comment"); Letter from Robert Stephens, Vice President, Mellon-Pictet International Management, Ltd., to John Wheeler, Secretary, SEC (June 13, 1985) ("Mellon-Pictet Comment").
- 6/ Letter from Directorate of Securities & Syndicates, Algemene Bank Nederland N.V., to John Wheeler, Secretary, SEC (May 22, 1985) ("Algemene Comment"); Letter from Anne R. Ronai, Vice President, Bankers Trust Company, to John Wheeler, Secretary, SEC (June 25, 1985) ("Bankers Trust Comment").
- 7/ Letter from Richard M. Phillips, Chairman, Federal Regulation of Securities Committee, Morton A. Pierce, Chairman, Subcommittee on International Securities Matters, and Lloyd Feller, Chairman, Subcommittee on Securities Markets and Market Structure, American Bar

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law firm, 8/ one broker-dealer, 9/ one issuer, 10/ an international securities administrators symposium, 11/ two securities regulators, 12/ and one United States government agency. 13/ The views of the commentators are summarized

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(footnote continued)

Association, to John Wheeler, Secretary, SEC (August 30, 1985) ("ABA Comment"); Letter from David Silver, President, Investment Company Institute, to John Wheeler, Secretary, SEC (June 24, 1985) ("ICI Comment"); Letter from Henry L. James, Director General, The National Association of Pension Funds Limited, to John Wheeler, Secretary, SEC (June 28, 1985) ("NAPF Comment"); Letter from William R. Harman, Chairman, Federal Regulation Committee, and Terrence Connelly, Chairman, Corporate Finance Committee, Securities Industry Association, to John Wheeler, Secretary, SEC (October 17, 1985) ("SIA Comment").

- 8/ Letter from Cary I. Klafter, Morrison & Foerster, to John Wheeler, Secretary, SEC (June 27, 1985) ("M&F Comment").
- 9/ Letter from Samuel E. Hunter, Senior Vice President, Merrill Lynch Capital Markets, to John Wheeler, Secretary, SEC (September 30, 1985) ("Merrill Comment").
- 10/ Letter from Walter R. Diehl, Jr., Vice President and Associate General Counsel, ITT Corporation, to John Wheeler, Secretary, SEC (June 27, 1985) ("ITT Comment").
- 11/ Letter from B. Imseng, Chairman, and K. Menche, Secretary, International Symposium of Securities Administrators, to John Wheeler, Secretary, SEC (June 25, 1985) ("ISSA Comment").
- 12/ Letter from Louise leBel Chevalier, Secretary, Commission des valeurs mobilières du Québec, to John Wheeler, Secretary, SEC (July 26, 1985) ("QSC Comment"); Letter from R.J. Schoer, Executive Director, National Companies and Securities Commission (Australia), to John Wheeler, Secretary, SEC (July 12, 1985) ("NCSC Comment").
- 13/ Letter from David C. Mulford, Assistant Secretary for International Affairs, Department of the Treasury, to John Wheeler, Secretary, SEC (June 18, 1985) ("Treasury Comment").

below by the issues and subissues upon which the Release solicited comment.

## I. International Trading

### A. Generally

1. Should the Commission take action to facilitate international trading?

Commentators recognized that the Commission has an important role to play in the internationalization process. The eight who commented generally on what this role should entail stated that the Commission should refrain from rulemaking that might be premature and permit the international trading markets to develop. The American Stock Exchange ("Amex"), Merrill Lynch Capital Markets ("Merrill"), and the American Bar Association ("ABA") suggested that the Commission could best contribute to the orderly development of global trading by working with market participants and the broker-dealer community to identify possible trouble areas and devise solutions that would not interfere with the evolution of the market. <sup>14/</sup> The National Association of Securities Dealers, Inc. ("NASD") and the ABA stated that the Commission should particularly concentrate on facilitating intermarket trading linkages and international settlement facilities. <sup>15/</sup>

The Toronto Stock Exchange ("Toronto"), Amex, and NASD recommended that the Commission undertake efforts to harmonize standards of securities regulation worldwide. <sup>16/</sup> The Amex asserted that the Commission should identify and eliminate unnecessary regulatory burdens that place the U.S. markets at a competitive disadvantage or encourage the growth of competitive markets abroad. <sup>17/</sup> Toronto suggested that multilateral discussions could be conducted under the auspices of the Federation of International Stock Exchanges and the International Association

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<sup>14/</sup> Amex Comment, supra note 2, at 5-6; Merrill Comment, supra note 9, at 3-4; ABA Comment, supra note 7, at 2.

<sup>15/</sup> NASD Comment, supra note 2, at 8-9; ABA Comment, supra note 7, at 2.

<sup>16/</sup> Toronto Comment, supra note 2, at 6; Amex Comment, supra note 2, at 6-7, 11; NASD Comment, supra note 2, at 9.

<sup>17/</sup> Amex Comment, supra note 2, at 6-7.

of Securities Commissions and Similar Organizations. 18/

Six of the seven commentators asserted that the Commission should not attempt to establish a structure for global trading markets. These commentators believed the interaction of competitive market forces would lead to the development of the structure necessary for fair and efficient international trading. 19/ ITT Corporation ("ITT"), however, recommended that, once global trading becomes widespread, the Commission should insure that the elements of an international market structure outlined by the Release are implemented. 20/

2. What is the extent to which extended trading opportunities are sought and used by investors at present?

The Securities Industry Association ("SIA") asserted that most activity in multiply-listed stocks occurs on the primary market during regular business hours. 21/ ITT's trading experience with its stock supports that view. ITT stated that virtually all trades in its stock occur in the U.S. on the New York Stock Exchange ("NYSE"), although the stock is listed on twelve major foreign exchanges. 22/ The Australian Associated Stock Exchanges ("AASE"), however, indicated that there is significant overseas activity in its national listings. 23/

The SIA stated that in-house trading by securities firms

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18/ Toronto Comment, supra note 2, at 6.

19/ AASE Comment, supra note 2, at 5; NASD Comment, supra note 2, at 9-10; Toronto Comment, supra note 2, at 6; QSC Comment, supra note 12, at 3; ABA Comment, supra note 7, at 2; Merrill Comment, supra note 9, at 3-4.

20/ ITT Comment, supra note 10, at 2.

21/ SIA Comment, supra note 7, at 4.

22/ ITT Comment, supra note 10, at 1.

23/ AASE Comment, supra note 2, at 1-2. The AASE stated that an estimated 30% by value of the trades Australian brokers report take place outside of Australia. Id.

is commonplace. 24/ Merrill and the NASD affirmed that upstairs trading does occur, and said that international broker-dealers frequently trade foreign equities around-the-clock by passing internal order books from time zone to time zone. 25/ U.S. equities, however, are traded around-the-clock less frequently. Merrill indicated that most overseas trading in U.S. equities occurs in Europe, and that some block trading of U.S. equities also takes place in Japan. 26/

3. To what extent is the international trading thus far institutional, proprietary, or retail? How does the nature of the trading affect the need for regulatory action?

Commentators stated that market professionals and institutional investors do the vast majority of international trading, and anticipate that these players will continue to dominate the global markets. 27/ Merrill noted that those U.S. retail customers who invest in foreign securities do so through U.S. broker-dealers during normal trading hours, and generally prefer owning ADRs to the foreign stocks themselves. 28/

Commentators concluded that the professional and institutional nature of global trading reduced the need for regulatory actions. Merrill stated that it made establishing a

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24/ SIA Comment, supra note 7, at 3-4.

25/ Merrill Comment, supra note 9, at 1-2; NASD Comment, supra note 2, at 2-3.

26/ Merrill Comment, supra note 9, at 1-2. Because the U.S. markets do not open until mid-afternoon European time, European investors frequently ask U.S. broker-dealers acting as principal to buy or sell blocks of U.S. stocks. Japanese brokers occasionally ask U.S. firms to offer blocks overnight to work during normal Japanese trading hours. Id.

27/ AASE Comment, supra note 2, at 6; Amsterdam Comment, supra note 2, at 2; Merrill Comment, supra note 9, at 2, 5; SIA Comment, supra note 7, at 3; Toronto Comment, supra note 2, at 5.

28/ Merrill Comment, supra note 9, at 2.

regulatory framework for the international markets less significant. 29/ Toronto opined that any such framework need not embody as extensive protections for retail investors as there are in the U.S. and Canadian markets. 30/

4. Is the demand for extended trading opportunities primarily based on a desire for liquidity during crisis conditions or for ease in executing routine transactions?

ITT stated that investors currently use extended trading opportunities only in unusual circumstances, and that those trades that occur outside domestic trading hours are generally in the U.S. OTC market and only occasionally overseas. 31/ The Chicago Board of Trade ("CBT"), however, opined that market participants increasingly will need routine access to foreign markets without having to adhere to artificial time constraints. 32/

5. Will extending trading opportunities result in spreading out existing trading over longer hours or will greater trading result?

One securities market and one futures market responded that making international markets more accessible to investors would result in greater trading volume. 33/

#### B. Market Structure

While commentators agreed that transnational trading would increase, there were differences of opinion over what would constitute the future structure of the international securities markets. The NASD, SIA, and ITT asserted that around-the-clock in-house trading by U.S. based securities firms was more likely

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29/ Merrill Comment, supra note 9, at 5.

30/ Toronto Comment, supra note 2, at 5-6.

31/ ITT Comment, supra note 10, at 1-2.

32/ CBT Comment, supra note 3, at 2.

33/ Toronto Comment, supra note 2, at 4; CBT Comment, supra note 3, at 2.

than a worldwide network of stock exchanges. 34/ The SIA further asserted that forthcoming changes in the London Stock Exchange ("London") would lead to increased trading on an upstairs principal basis, 35/ but Merrill cautioned that the effect of London's expansion of trading in U.S. securities on the present off-board market in listed securities remains to be seen. 36/

Four stock exchanges and a securities regulator, in contrast, argued for the establishment of an interconnected network of stock exchanges. 37/ The Amex indicated that it would continue to forge links with foreign markets. 38/ The Commission de valeurs mobilières du Québec ("QSC") and Toronto stated that exchanges should link their automated market information and execution systems to form that network. 39/ The Tokyo Stock Exchange ("Tokyo") and Toronto indicated that simultaneous trading among markets in the same or near time zones was practicable. 40/ The Amsterdam Stock Exchange ("Amsterdam") suggested that multiple simultaneous trading in international equities should take place in the currency of the home market according to the procedures and routines of the home market. 41/

Commentators generally did not express a view on the prospects for coordinated around-the-clock trading between domestic and

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34/ NASD Comment supra note 2, at 8; SIA Comment, supra note 7, at 3; ITT Comment, supra note 10, at 2.

35/ SIA Comment, supra note 7, at 3.

36/ Merrill Comment, supra note 9, at 3.

37/ In fact, Toronto asserted that regulators should not approve intermarket linkages unless those linkages involve exchanges with satisfactory regulatory schemes. Toronto Comment, supra note 3, at 21.

38/ Amex Comment, supra note 2, at 2.

39/ QSC Comment, supra note 12, at 2; Toronto Comment, supra note 2, at 7-8.

40/ Tokyo Comment, supra note 2, at 3; Toronto Comment, supra note 2, at 19-21.

41/ Amsterdam Comment, supra note 2, at 7.

foreign exchanges by arranging for consecutive trading of world-class securities. Toronto did indicate, however, that arrangements for consecutive trading would take longer to achieve than those for simultaneous trading. 42/

1. Consolidated Reporting

- a. Should transaction reporting requirements for participants in the U.S. securities markets be expanded? Should NASD member firms be required to report overseas trades in U.S. stocks to a consolidated system on a last sale basis?

National Securities Clearance Corporation ("NSCC") supported expanding current trade reporting requirements to capture and reflect last sale information on trades in U.S. securities occurring overseas. To adequately assess its market exposure and collateralize risks, NSCC stated that it must know the extent of its participants' holdings in particular issues and that the prices it uses to mark its open positions are accurate. 43/

- b. Would it be desirable or practical to develop an international consolidated reporting system in stocks traded globally on an active basis?

Commentators generally agreed that the increased dissemination of transaction reporting would facilitate the establishment of global trading markets. The National Association of Pension Funds Ltd. ("NAPF") and the CBT supported making as much market information available as technology currently permits. 44/ Amsterdam similarly stated that direct electronic intermarket data links should be studied as a means of enhancing transaction

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42/ Toronto Comment, supra note 2, at 8-9. Toronto also suggested an alternative market structure in which international securities could be listed only on their home market and foreign nonmember brokers could trade those stocks by direct electronic access to the floor of that exchange. Id. at 7, n.7.

43/ NSCC Comment, supra note 4, at 8.

44/ NAPF Comment, supra note 7, at 2; CBT Comment, supra note 3, at 2.

reporting. 45/ The AASE and QSC recommended that self-regulatory organizations ("SROs") worldwide collect and disseminate accurate and timely transaction reports for internationally traded securities, 46/ and the AASE suggested that this concerted action could lead to the development of an international consolidated system if market demand was sufficient. 47/ ITT stressed that increased in-house trading would make developing an international consolidated reporting system more important and opined that, without such a system, only those market participants with access to specialized segments of the broker-dealer community would be aware of trading outside normal hours. 48/

Two commentators highlighted the practical difficulties of developing a consolidated reporting system for globally traded stocks. Merrill stated that a consolidated reporting requirement would be impractical unless other markets developed automated systems and transaction reporting tapes, and a more formal global market with greater U.S. investor participation evolved. 49/ Toronto asserted that wide differences in trading systems and trade reporting among world markets made prospects for a consolidated system remote, and the need for currency conversion facilities posed additional obstacles. 50/

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45/ Amsterdam Comment, supra note 2, at 4. For the immediate future, Amsterdam endorsed using the infrastructure that commercial vendors provide. Id.

46/ AASE Comment supra note 2, at 4; QSC Comment, supra note 12, at 4.

47/ AASE Comment, supra note 2, at 4.

48/ ITT Comment, supra note 10, at 2.

49/ Merrill Comment, supra note 9, at 2-3.

50/ Toronto Comment, supra note 2, at 13-16, 14 n.14. Toronto indicated that developing currency conversion facilities is complex even where the securities markets are as similar as those in the U.S. and Canada. Moreover, Toronto stated that the conversion facilities developed for its linkages with the American and Midwest Stock Exchanges will disseminate converted prices that inevitably differ from the standard eighth point price intervals of the North American exchanges' computer software. Id. at 15-16.

Two commentators questioned the desirability of an international consolidated tape. The SIA asserted that the current paucity of simultaneous or coordinated exchange trading coupled with the efficiency of existing international trading mechanisms made a tape unnecessary. 51/ The NASD claimed that any attempt to foster the development of an international consolidated reporting system might appear to be an attempt to force the integration of foreign and domestic markets. 52/

- c. Could uniform reporting requirements for securities traded internationally be devised?

Tokyo stated that harmonizing the information systems of various marketplaces may become necessary as cross-border equity trading grows. Tokyo recognized that harmonization would be difficult because of differing trading and reporting systems, systems, but recommended that the effort begin gradually with securities listed in multiple international markets. 53/ The CBT also endorsed harmonization. 54/ Amsterdam suggested that the problem of different reporting requirements could be obviated if each market trading a particular security were to utilize the reporting requirements of the security's home market and country. 55/

- d. What level of international trading activity would be necessary before the cost of a consolidated system would be justified? As an interim measure, would it be feasible to have a system that disseminates different kinds of information from various markets?

While commentators generally agreed that more international trading would be necessary to justify the cost of a tape,

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51/ SIA Comment, supra note 7, at 4.

52/ NASD Comment, supra note 2, at 8.

53/ Tokyo Comment, supra note 2, at 4.

54/ CBT Comment, supra note 3, at 2-3.

55/ Amsterdam Comment, supra note 2, at 3. Amsterdam also recommended that trading and, thus, reporting also be in the currency of the home market and country. Id. at 6. See also infra text accompanying note 69.

none provided specific information on what the requisite volume might be. With respect to a possible interim system with nonuniform reporting, Toronto stated that disseminating real-time last sale information for the U.S. and Canadian markets together with nonreconciled periodic volume data from markets without last sale reporting would confuse investors. 56/

## 2. Consolidated Quotations

### a. Is or will a consolidated quotation system be needed internationally?

The eight commentators who responded reiterated the views they expressed with respect to the desirability of an international consolidated reporting system. The NAPF, CBT, AASE, QSE, and Amsterdam stressed the importance of widespread dissemination of international quotation information. 57/ In particular, Amsterdam stated that investors would not be able to determine to which market to direct orders in international listings without knowing bids and offers worldwide. 58/

Merrill and Toronto highlighted the practical difficulties of developing an international consolidated quotation system. 59/ Merrill and the SIA also questioned the desirability of developing such a system at this time. Merrill stated that individual investors presently do not trade directly in foreign markets, and consolidated quotes primarily would benefit a small group of market professionals who already have access to that data through their own sophisticated communications systems. 60/ The NASD generally questioned the desirability of a consolidated system. 61/

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56/ Toronto Comment, supra note 2, at 14 n.14.

57/ NAPF Comment, supra note 7, at 2; CBT Comment, supra note 3, at 2; AASE Comment, supra note 2, at 4; Amsterdam Comment, supra note 2, at 4.

58/ Amsterdam Comment, supra note 2, at 4.

59/ Merrill Comment, supra note 9, at 2; Toronto Comment, supra note 2, at 15-16.

60/ Merrill Comment, supra note 9, at 2-3; SIA Comment, supra note 7, at 4.

61/ NASD Comment, supra note 2, at 8.

- b. How active would simultaneous trading have to be for consolidated quotations to be justified?

While commentators generally agreed that more international trading would be necessary, none provided specific projections.

- c. Is the market information presently available in the international markets for debt sufficient to ensure efficient pricing?

The NAPF expressed serious concerns over the adequacy of market information currently available in the international bond markets. 62/

### 3. Intermarket Linkages

- a. Would pricing disparities be likely to develop from multiple international trading, and if so, would arbitrage activity bring the markets into line? If not, should there be mechanisms such as intermarket linkages to permit orders to be routed to the market with the best price?

Merrill, the SIA, the AASE, and the CBT stated that pricing disparities inevitably would result from the same security trading simultaneously on multiple international markets, but that arbitrage activity likely would eliminate or substantially reduce price differences between markets. 63/ Nevertheless, Merrill, the SIA, and the AASE supported the eventual development of intermarket linkages if necessitated by commercial considerations rather than regulatory initiatives. 64/ In fact, Merrill asserted that meaningful international linkages would be a prerequisite for an effectively functioning global marketplace, for relying on arbitrage to correct pricing disparities was somewhat inefficient. 65/

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62/ NAPF Comment, supra note 7, at 2.

63/ Merrill Comment, supra note 9, at 2; SIA Comment, supra note 7, at 4; AASE Comment, supra note 2, at 4; CBT Comment, supra note 3, at 3.

64/ Merrill Comment, supra note 9, at 2-3; SIA Comment, supra note 7 at 4-5; AASE Comment, supra note 2, at 4.

65/ Merrill Comment, supra note 9, at 2-3. Merrill cautioned

(footnote continued)

The Amex commented that arbitrageurs play an important role in keeping prices in dually listed Amex and Toronto issues consistent, and stated that significant price disparities between the U.S. and Canadian markets are relatively rare. The Amex noted, however, that orders from one country generally do not benefit from the better price in another unless the order size and price differential are large enough to cover the arbitrageur's transactional costs and allow some profit. The Amex asserted that intermarket linkages would enhance and to some degree replace arbitrage activity by making it possible for orders to get the best price available in either the U.S. or Canada after a small transaction fee. 66/

Toronto and Amsterdam supported the establishment of electronic trading links between markets as a matter of course. Both agreed that linkages would enhance the quality of international trading. 67/ In this connection, Toronto asserted that linkages would enhance depth and liquidity, lead to increased automation, and serve as the impetus for harmonizing securities laws, trading rules, and settlement procedures. 68/ Amsterdam contended that, if a linked international trading network were to be developed, it should be based on what it called the "home-market" system. Under that system, markets around the globe trading a particular security would do so in the home-market's currency based on home-market routines and procedures, thus insuring the comparability of quotes and prices from all markets. 69/

Tokyo, however, stated that it was not prepared at this time to enter into linkages with markets in other countries.

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(footnote continued)

that convincing international trading partners of the need for intermarket linkages would be extremely difficult, and asserted that such a network could not be established unless all groups of market participants had an incentive to participate. Id.

66/ Amex Comment, supra note 2, at 4-5.

67/ Toronto Comment, supra note 2, at 7-9; Amsterdam Comment, supra note 2, at 4.

68/ Toronto Comment, supra note 2, at 7-9.

69/ Amsterdam Comment, supra note 2, at 6.

Tokyo asserted that Japan's location and time zone presently made simultaneous trading in world class securities on a U.K.-U.S.-Japan nexus impracticable. 70/

The NASD viewed intermarket linkages from a different perspective. The NASD asserted that firms would develop their own linkages as part of their in-house trading capabilities, and a global network for automatically executing transactions would evolve once firms found it economical to stop doing business by telephone. 71/

- b. Would it be feasible or desirable to develop links between foreign over-the-counter trading of U.S. securities and trading in the U.S. securities markets?

Toronto indicated that the Commission should approve only intermarket linkages involving exchanges. Toronto argued that exchange markets, unlike the upstairs interdealer market, have the market surveillance facilities and regulatory framework necessary to safeguard investor protection. 72/

- c. Would intermarket linkages developed likely involve exclusive agreements between a national securities exchange and a foreign market, and if so, would that exclusivity impose a burden on competition inconsistent with the provisions of the Exchange Act?

Amsterdam asserted that intermarket linkages should not be exclusive, and that markets should be prepared to link with more than one other market. 73/

## B. Securities Processing

1. Are international clearing links necessary for the further expansion of international trading markets?

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70/ Tokyo Comment, supra note 2, at 6.

71/ NASD Comment, supra note 2, at 8.

72/ Toronto Comment, supra note 2, at 20-21.

73/ Amsterdam Comment, supra note 2, at 4.

Commentators agreed that efficient, safe, and accurate comparison, clearance, and settlement systems were necessary for the growth of international trading, and stated that additional and improved links between central clearing and depository organizations would be desirable. 74/ Indeed, NSCC emphasized that intermarket linkages could not function effectively without companion securities processing mechanisms. 75/ International Commodities Clearing House Limited ("ICCH") and four other commentators stated that any such linkages should be reciprocal two-way interfaces in which the foreign and U.S. clearing agencies are members of each other. 76/ Tokyo noted that it would continue to develop links with foreign depositories and clearing agencies when necessary for efficient custodial services for Japanese stocks listed on foreign exchanges or foreign stocks listed on Tokyo. 77/ Commentators generally noted, however, that a major practical obstacle to the development of international clearing linkages was resolving currency conversion problems. 78/ Only the CBT questioned the necessity of establishing formal linkages. 79/

2. Should future clearing links be developed on an incremental basis or should concerned parties consider creating a centralized, internationally-

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74/ See, e.g., ISSA Comment, supra note 11, at 2.

75/ NSCC Comment, supra note 4, at 2-3.

76/ ICCH Comment, supra note 4, at 2-5. See also CDS Comment, supra note 4, at 13; ISSA Comment, supra note 11, at 3; MCC/MSTC Comment, supra note 4, at 3-4; QSC Comment, supra note 12, at 3-4.

77/ Tokyo Comment, supra note 2, at 8.

78/ See, e.g., CDS Comment, supra note 4, at 18. The CDS stated that trades should be settled in the currency in which the trade took place for international clearing linkages to operate most efficiently. Id. Amsterdam's suggested "home-market" system would achieve that result; securities would be traded in markets around the globe in the home-market's currency, thus obviating the need for currency conversion facilities. See Amsterdam Comment, supra note 2, at 6. See also supra text accompanying note 69.

79/ CBT Comment, supra note 3, at 3.

governed clearing or depository entity for international trades?

While the International Symposium of Securities Administrators ("ISSA"), Toronto, and the SIA stated that the creation of a central international clearing or depository entity might be desirable, they, together with five other commentators, concluded that the incremental development of links between existing institutions would be both preferable and practicable. 80/ The ISSA asserted that establishing a special global securities processor would be impracticable because private investors, institutional investors, and large banks and broker-dealers have differing resources and requirements. 81/ The Midwest Clearing Corporation and Midwest Securities Trust Company ("MCC/MSTC") indicated that there would be problems in the ownership, financing, and operational control of a single international entity, and opined that it would not be welcomed by existing clearing agencies. 82/

3. Should the Commission develop specific standards to determine whether foreign clearing agencies should be permitted to participate in a link with a U.S. clearing agency or be required to register in the U.S. under Section 17A of the Exchange Act?

NSCC and MCC/MSTC argued that it would be premature to develop eligibility standards with which all clearing agencies and marketplaces would have to comply, although MCC/MSTC

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80/ ISSA Comment, supra note 11, at 2; Toronto Comment, supra note 2, at 16 n.17; SIA Comment, supra note 7, at 6. See also Amsterdam Comment, supra note 2, at 4-5; CDS Comment, supra note 4, at 27; Merrill Comment, supra note 9, at 4; MCC/MSTC Comment, supra note 4, at 2; QSC Comment, supra note 12, at 3-4.

81/ ISSA Comment, supra note 11 at 2. The ISSA stated that, while large entities with branches or subsidiaries overseas could become direct members of a foreign central clearing and depository entity, private and institutional investors might find it better to be served through domestic custodians. Id.

82/ MCC/MSTC Comment, supra note 4, at 2.

allowed that such standards might be workable if made sufficiently flexible to encompass the wide variety of foreign clearing agencies. Both endorsed the current staff practice of determining foreign clearing agency eligibility for international linkage participation through no-action letters. 83/ While NSCC preferred the no-action approach, it suggested as an alternative guidelines similar to those the Division of Market Regulation uses for determining whether to register a U.S. clearing agency. NSCC stated that, after additional experience is gained with international clearing arrangements, guidelines would enable clearing agencies to rely upon examples in designing linkages and expect that their actions would receive Commission approval. 84/

Two commentators emphasized the usefulness of specific eligibility standards. ICCH stated that, to facilitate the development of reciprocal clearing interfaces, the Commission should publish guidelines on how proposed amendments to U.S. clearing agency rules designed to implement such a linkage would be analyzed under Section 19 of the Exchange Act. 85/ The AASE recommended that countries interested in international clearing linkages should establish common standards for linkage participation, and noted that these standards would provide Australian clearing facilities with guidance on how best to upgrade their systems. 86/

Merrill indicated that it was too early to decide whether foreign clearing agencies entering into links should be required

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83/ NSCC Comment, supra note 4, at 5-7; MCC/MSTC Comment, supra note 4, at 3. NSCC nevertheless recognized that the no-action approach has certain weaknesses. For example, parties tend to rely on existing letters and do not seek the advice of the Commission staff at a sufficiently early point in the linkage developmental process. NSCC recommended that, if the Commission continues to follow a no-action approach, the Commission should make clear that links would not be approved without prior Commission confirmation of the applicability of prior no-action positions. NSCC Comment, supra note 4, at 6-7.

84/ NSCC Comment, supra note 4, at 5.

85/ ICCH Comment, supra note 4, at 5-6.

86/ AASE Comment, supra note 2, at 6-7.

to register in the U.S. under § 17A of the Exchange Act. 87/ The ISSA, CDS, and MCC/MSTC, however, opposed requiring § 17A registration. The ISSA and CDS asserted that the central depository of one country should not have to register with or report to regulatory authorities in another country as a condition of participating in a linkage with a clearing agency in that country. 88/ MCC/MSTC argued that foreign clearing agencies would find § 17A registration burdensome and, therefore, would not establish new linkages with U.S. securities processors. 89/

4. Should U.S. clearing agencies develop special admission standards for foreign clearing agencies that seek to become members of U.S. clearing agencies?

NSCC and CDS commented that foreign clearing agencies should become members of U.S. clearing agencies based on membership standards comparable to those applicable to U.S. participants. NSCC reasoned that foreign clearing agencies are too diverse for the development of special uniform membership criteria to be practicable, and the existence of such criteria could hamper the structure of potential linkage relationships. As a substitute for uniform standards, NSCC suggested that a due diligence examination be required of foreign clearing agencies proposed to be admitted to membership. 90/ CDS stated that separate membership standards were unnecessary because the foreign clearing agency would be liable for the accounts of its members. 91/

5. How can safeguarding of securities and funds be insured when one or more U.S. clearing agencies involved in future two-way interfaces are exposed to regulatory requirements and financial risks that could be very different from those encountered in this country?

CDS asserted that its participation in U.S. clearing agencies

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87/ Merrill Comment, supra note 9, at 4.

88/ ISSA Comment, supra note 4, at 3; CDS Comment, supra note 4, at 24-25.

89/ MSCC/MSTC Comment, supra note 4, at 2-3.

90/ NSCC Comment, supra note 4, at 7.

91/ CDS Comment, supra note 4, at 25-26.

does not expose the U.S. national clearance and settlement system to financial risks of a degree or kind different from those created by the acceptance of a U.S. participant in a U.S. clearing agency. CDS submitted, therefore, that the safeguarding mechanisms applicable to foreign clearing agencies becoming participants in foreign counterparts should be similar to the safeguards established by that clearing agency for its domestic participants, and added that the only additional requirement should be that the foreign clearing agency agree to abide by the laws and submit to the courts of the jurisdiction in which the counterpart clearing agency is located. 92/

Merrill, in contrast, suggested that establishing a separate clearing entity to link the U.S. national clearance and settlement system with foreign clearance and settlement systems might be prudent. Merrill stated that such a separate entity might help limit the financial exposure of the U.S. broker-dealer community. 93/ The ISSA also said that the separate clearing entity concept deserves special attention. 94/

#### C. Barriers to Entry

1. What effect on international trading do limitations on broker-dealer access to foreign markets have and what actions, if any, should be taken to reduce these barriers?

The Department of the Treasury ("Treasury") stated that it is working through the Organization for Economic Cooperation and Development ("OECD") to promote the rights of U.S. banks and securities firms overseas. 95/ The SIA agreed that U.S. firms should have the opportunity to operate abroad without competitive restrictions, as foreign firms do in the U.S. The SIA noted that, while progress has been made, significant limitations on access exist in a number of important markets. The SIA cautioned, however, that it may be premature for the Commission to take

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92/ CDS Comment, supra note 4, at 26-27.

93/ Merrill Comment, supra note 9, at 4.

94/ ISSA Comment, supra note 11, at 2.

95/ Treasury Comment, supra note 13, at 1.

action to reduce barriers because access limitations may fall as a result of economic forces. 96/

2. What barriers, if any, result from the broker-dealer regulation of various countries? Does this regulation significantly limit broker-dealers from entering foreign markets?

The NASD recommended that the Commission review the U.S. domestic securities laws applicable to international transactions, identify which constitute barriers to entry, and initiate steps to remove those barriers. 97/ The CBT proposed that the Departments of State or Commerce, with assistance from affected regulatory agencies, work to reduce and harmonize market regulation worldwide in order to facilitate market entry and enhance market performance. 98/

Algemene Bank Nederland N.V. ("Algemene") asserted that the Glass-Steagall Act is a barrier to universal bank entry into the U.S. securities markets. Algemene stated that, because of its U.S. commercial banking activities, it must form a broker-dealer subsidiary to engage in a securities business in the U.S. 99/

## II. Multinational Distributions of Securities

- A. To what extent could the investor protections afforded by the Exchange Act be maintained and coordinated with those of other countries, particularly in the context of the distribution of securities on a multinational basis?

Tokyo stated that exchange regulations and the Japanese securities laws prohibit manipulative trading even in the case of a cross-national distribution. 100/ Amsterdam and the

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96/ SIA Comment, supra note 7, at 7-9.

97/ NASD Comment, supra note 2, at 9.

98/ CBT Comment, supra note 3, at 3.

99/ Algemene Comment, supra note 6, at 1.

100/ Tokyo Comment, supra note 2, at 9.

AASE agreed that securities regulators and marketplaces should insure that investors are protected, and that the evolution of the global market should not be constrained by the lack of harmonization. The AASE asserted, however, that certain standards would be unacceptable in Australia. 101/

- B. To what extent could the Commission's prior approach to international stabilization be continued or refined?

The ABA endorsed the Commission's current case-by-case approach to interpreting Rules 10b-6 and 10b-7 under the Exchange Act, stating that no single legislative or rulemaking approach would be suitable for dealing with all the hypothetical issues that could arise as a result of simultaneous distributions. The ABA noted, however, that the Commission might be able to provide more general guidance as multinational activity increases and similar situations recur. The ABA said that guidelines on the interaction of Rule 10b-6 and foreign securities distributions and market practices would reduce uncertainty and facilitate internationalization, and suggested that guidelines could be general indications of: (1) specific Commission concerns where Rule 10b-6 is technically incompatible with foreign rules and practices; (2) situations in which the staff would be receptive to granting a no-action position or an exemptive order on the basis that, while there might be technical violations of Rule 10b-6, the intent and policy behind the rule would not be violated; and (3) elements of factual situations which would cause the staff to be inclined not to take a no-action position or issue an exemptive order. 102/

The SIA agreed that the Commission's case-by-case approach has balanced investor protection with the legitimate interests of issuers and underwriters. The SIA recommended, however, that the Commission consider liberalizing amendments to Rules 10b-6 and 10b-7 for offerings outside the U.S. because rules designed for the U.S. markets often are inapplicable to foreign markets. 103/

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101/ Amsterdam Comment, supra note 2, at 5; AASE Comment, supra note 2, at 5-6.

102/ ABA Comment, supra note 7, at 4-5.

103/ SIA Comment, supra note 7, at 10-11.

### III. International Enforcement Problems

- A. What mechanisms could be developed to monitor trading in international markets?

The Amex, Toronto, Amsterdam, and the CBT stated that markets should share market information and cooperate on international market surveillance. 104/ Amex suggested that this might be accomplished by either formal agreement between linked foreign and domestic markets or the creation of an international inter-market surveillance group. 105/ Tokyo asserted that investors in multinationally listed securities were protected at least for the time being by the surveillance mechanisms of individual markets, but recognized that stock exchanges will have to cooperate more closely in the future by exchanging information on trading in multinational listings. 106/

- B. What measures could be taken to address the possible erosion of trading halts that could affect the integrity of the U.S. securities markets?

Toronto, Tokyo, and Amsterdam asserted that markets should act in concert to halt trading in multinational listings in appropriate circumstances. 107/ Toronto suggested that inconsistent practices involving trading halts were a barrier to the effective integration of the North American markets, and that upon the occurrence of material corporate developments every market trading an interlisted security should halt trading in that issue for sufficient time to place market participants everywhere on an equal footing. Asserting that markets should not seek a competitive advantage by recommencing trading earlier, Toronto recommended that the Commission and Canadian securities regulators should adopt rules requiring that all trading (including that in the third market) be

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104/ Amex Comment, supra note 2, at 8-9; Toronto Comment, supra note 2, at 11-13, 18; Amsterdam Comment, supra note 2, at 5, 7; CBT Comment, supra note 3, at 3.

105/ Amex Comment, supra note 2, at 8.

106/ Tokyo Comment, supra note 2, at 10.

107/ Toronto Comment, supra note 2, at 18-19; Tokyo Comment, supra note 2, at 10; Amsterdam Comment, supra note 2, at 5.

halted until the primary North American market determines that trading may recommence. 108/

- C. Would it be practicable to reach bilateral or multilateral agreements on securities law enforcement, possibly through the aegis of a coordinating body of national regulatory entities?

The Treasury, Amex, ABA, SIA, and National Companies and Securities Commission of Australia ("NCSC") endorsed working for mutually agreeable bilateral or multilateral accords on international securities law enforcement. 109/ In fact, the NCSC stated its willingness to discuss with the Commission the terms of a bilateral agreement to formalize their existing informal arrangements. 110/ The QSC, however, indicated that formal bilateral or multilateral enforcement agreements might not be necessary if assistance were limited to securities regulators instead of governments. 111/

The Treasury, ABA, and SIA emphasized that negotiations involving international regulatory cooperation should be conducted under the auspices of existing international organizations where the U.S. government already has work underway. The Treasury recommended the OECD as a forum, while the ABA recommended the Bank for International Settlements. 112/

#### IV. Other Issues

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108/ Toronto Comment, supra note 2, at 18-19.

109/ Treasury Comment, supra note 13, at 2; Amex Comment, supra note 2, at 10-11; ABA Comment, supra note 7, at 2-4; SIA Comment, supra note 7, at 9-10; NCSC Comment, supra note 12, at 2. Amex cautioned that accords such as these only would be successful if securities laws violations in one jurisdiction were considered violations in other jurisdictions, and suggested that the principal financial centers develop uniform standards in key areas. Amex Comment, supra note 2, at 10-11.

110/ NCSC Comment, supra note 12, at 2.

111/ QSC Comment, supra note 12, at 5.

112/ Treasury Comment, supra note 13, at 2; ABA Comment, supra note 7, at 3-4; SIA Comment, supra note 7, at 10.

#### A. Rights Offerings

Three international pension fund managers, 113/ a custodial bank, 114/ and a law firm 115/ expressed concern that U.S. investors in foreign securities are excluded from participating in the unregistered rights offerings which foreign issuers frequently use as a substitute for dividends, and suggested that the Commission create a safeharbor permitting the offering of these unregistered rights to U.S. institutional investors without violating the Securities Act of 1933.

#### B. Short Sales

The SIA urged the Commission to study the applicability of Rule 10a-1 under the Exchange Act to transactions executed abroad. The SIA asserted that, given the absence of continuous transaction reporting in foreign markets and the difficulty of determining last sale prices for transactions executed abroad when U.S. exchange markets are closed, it is unclear that the short sale rule was ever intended to apply to overseas transactions. 116/

#### C. One Share-One Vote

The NAPF stated that it has sought to limit the issuance of nonvoting shares in the U.K., and expressed concern over NYSE proposals to permit the continued listing of companies with dual capitalization. The NAPF warned that U.K. companies unable to issue nonvoting securities in the U.K. could use the international markets to do so through the NYSE, thereby diminishing the rights of U.K. shareholders. 117/

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113/ Baring Comment, supra note 5, at 1; BT Comment, supra note 5, at 1-2; Mellon-Pictet Comment, supra note 5, at 1.

114/ Bankers Trust Comment, supra note 6, at 1-2.

115/ M&F Comment, supra note 8, at 1-3. Morrison & Foerster commented on behalf of G.T. Capital Management, Inc.

116/ SIA Comment, supra note 7, at 10-11. Although the New York Stock Exchange ("NYSE") did not discuss this topic in its comment letter, the NYSE is studying a proposal formulated in response to the growth of international trading that would narrow the scope of its short sale rule. See NYSE Comment, supra note 2, at 1.

117/ NAPF Comment, supra note 7, at 1-2.

D. Tender Offer Disclosure

The Panel on Take-overs and Mergers of the London Stock Exchange stated its interest in insuring that certain share transactions during takeovers would continue to be disclosed on a timely basis as the international markets develop. 118/

E. Investment Company Matters

The Investment Company Institute ("ICI") stated that trading outside normal NYSE trading hours might raise issues concerning the pricing of fund shares for sale and redemption, and the purchase of the securities of certain foreign issuers, such as diversified banking institutions, might raise concerns under Section 12 of the Investment Company Act. The ICI also recommended seeking bilateral or multilateral agreements for the reciprocal sale of American funds in Europe and European funds in the U.S. 119/

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118/ LSE Comment, supra note 2, at 1.

119/ ICI Comment, supra note 7, at 1-2.

C H A P T E R V

A P P E N D I X B

**SUMMARY OF  
INTERNATIONALIZATION ROUNDTABLE  
February 17, 1987**

**Prepared by  
THE DIVISION OF MARKET REGULATION  
August 1, 1987**

## Internationalization Roundtable

### Executive Summary

The morning Roundtable discussion centered on secondary market issues. The panel focused specifically on trading mechanisms, clearance and settlement, regulatory adaptations to accommodate the internationalization of the markets, regulatory oversight and barriers to entry.

Although there was general agreement on the inevitability of the convergence of the world's capital markets, participants did not agree on the form these multinational markets ultimately would take. Several participants believed that upstairs markets would predominate and would maximize the capital efficiency of the global market. Others believed that electronically linked exchange markets would prove to be preferable to upstairs markets. There was general agreement, however, that, regardless of the future structure, issuers' home countries would continue to be their primary source of liquidity.

The panel also generally agreed that the single largest challenge facing the industry is the development of efficient and safe clearance and settlement facilities. Participants were encouraged by the development of linkages among the world's clearance and settlement systems but also noted that the problem of widely differing settlement cycles and systems capabilities still needs to be addressed.

The self-regulatory organizations ("SROs") represented on the panel stressed the importance of developing effective mechanisms for the exchange of surveillance and enforcement information. It was stressed that such mechanisms will be increasingly important, for example, to U.S. SROs in examining their members that have foreign affiliates. Currently, their ability to examine these foreign affiliates is extremely limited.

The Commission also asked the participants to discuss whether regulatory adaptations would be necessary to facilitate the process of internationalization (e.g., modifications to the short-sale rule or off-board trading restrictions). Although participants applauded the Commission and the SROs' willingness to re-examine their regulatory structures, they also cautioned against a "race to the bottom." Participants stressed that U.S. markets are perceived as fair and equitable and that investors generally believe that such markets provide significant benefits.

The final topic was the issue of whether foreign firms still face barriers to entry to domestic markets. Participants, commenting as U.S. firms seeking entry to other markets and as foreign firms seeking entry to U.S. markets, agreed that substantial progress has been made in the breaking down of legal barriers to entry. They also agreed that significant "cultural" barriers, particularly in terms of understanding the foreign jurisdiction's regulatory structure and breaking into markets, still exist. One example cited was gaining access to underwriting syndicates.

The afternoon Roundtable discussion covered primary offerings in the international context and foreign broker-dealer activity in the United States. The participants discussed the application of Securities Act requirements to offshore primary offerings by United States firms. The participants agreed that there should be a territorial approach to the application of the Securities Act. They also agreed that the Securities Act imposes certain artificial impediments and costs on the operation of the markets. In addition, there was a consensus that although some restriction on "flowback" -- the entry back into the United States of the unregistered securities of a domestic issuer -- is necessary to prevent evasion of the Securities Act, the present approach must be simplified.

The panel discussed the benefits of creating a "free trade zone" for the trading by institutions of securities that would be exempt from registration. The participants recognized that the free trade zone concept is thus far undefined and unclear and discussed possible limitations on the eligible issuers of securities. Also, the discussions focused on the ability of foreign firms to conduct public securities offerings in the United States. The panelists commented on the advantages of using a reciprocal prospectus approach under which offering documents accepted in the home jurisdiction could be used in the United States. Some participants noted their skepticism with the reciprocal prospectus concept and noted that it should be limited at first to debt, and possibly equity offerings of certain world-class issuers.

The panelists then discussed efforts by foreign broker-dealers to enter United States markets and the circumstances under which registration should be required. The participants had differing views as to whether foreign broker-dealers, who, for example, only disseminated research or dealt only with registered broker-dealers in the United States should be required to become registered broker-dealers in the United States.

Finally, there was a brief presentation by the manager of an international fund who indicated that successful performance comes from selection of markets rather than particular securities. In this regard, the fund manager indicated that traditional disclosure concerning issuers and their securities was less important than knowledge of foreign markets and trends.

#### Summary of Proceedings

On February 17, 1987, the Commission held a Roundtable on Internationalization, a public meeting at which numerous experts discussed various aspects of the internationalization of the securities markets. The list of participants and the specific issues discussed are contained in the attached Briefing Memorandum (Attachment A), that was distributed to Commissioners and participants before the meeting and is publicly available. This document summarizes the Roundtable discussion and the written remarks submitted by some participants. The written remarks are attached as Attachment B.

The Chairman began the proceedings by welcoming the participants and stating that the internationalization of the securities markets offers great benefits and challenges, with the most important areas of concern being the balance of trade

and payments, the international monetary system, restructuring by less developed countries, and off-balance sheet bank-guaranteed swaps and other credits. The Chairman added that the areas of specific interest to the Commission include international surveillance and enforcement, clearance and settlement, and disclosure systems and practices.

After each participant identified himself, the Chairman introduced the first topic, which was international secondary market trading mechanisms.

Messrs. Unruh (Toronto Stock Exchange), Fernandez (Nomura Securities) and Meyjes (Citicorp Investment Bank) presented prepared remarks. Mr. Unruh stated that the first question is the role of dealer markets in the developing global market structure. Mr. Unruh indicated that upstairs markets are preferable to floor markets. Mr. Unruh believed that the real question was which of the two principal different types of markets would predominate: Markets where prices primarily are determined by the interaction of orders represented on an agency basis by broker-dealers with centralized limit order protection; or markets where prices primarily are determined by the interaction of dealers with other dealers and customers based upon the dealers quotations. Mr. Unruh indicated that dealer markets linked by consolidated quotation dissemination and price reporting systems could be used internationally with a core group of international stocks. Mr. Unruh recognized the structural problems with that approach, and emphasized the need of dealer, quotation-driven markets for larger amounts of

capital. Mr. Unruh stated, however, that quotation-linked markets could become unstable. Mr. Birnbaum (New York Stock Exchange) disagreed with Mr. Unruh and stated that exchange markets are preferable to upstairs markets.

In his written remarks, Mr. Unruh elaborated on his ideas, stating that "book-based" market linkages are preferable and would maximize the capital efficiency of the global market for the stocks included. Such a system would involve bilateral agreements to route orders to the home market and would require two thirds of the capital required by the specialist system.

Mr. Fernandez stated that Nomura engages in 24-hour trading and is interested in various international linkages and other experiments the exchanges and others are conducting. The biggest problem from Nomura's point of view is the lack of clarity in overseas trading mechanisms, such as how to mark tickets and how to determine the time of trade for certain transnational trades. Nomura indicated that generally it is unsure whether firms have the burden to turn away a deal until they are told it is appropriate and, if so, whether regulators should beef up their staff to answer these kinds of questions. The alternative, Mr. Fernandez believed, is chasing transactions offshore.

Mr. Meyjes stated that he believes there is no question about the nature of the convergence of marketplaces, indicating for instance that about 40% of transactions in French securities, and as many as 90% of transactions in Swedish securities, occur in London. In all, about 16% of stock exchange volume worldwide involves counterparts not located in the same country.

In the opinion of Mr. Meyjes, the principal constraint on globalization of equity markets is that liquidity outside a security's home country is hard to achieve. He believes that, as a practical matter, the home market would continue to determine volume, prices and costs of funding positions. Mr. Meyjes also indicated that the SEC should be particularly interested in settlement problems and concluded that internationalization of the markets would continue but the industry and regulators both must accept that there would be setbacks along the way.

Mr. Davin (NASD) agreed with Mr. Meyjes that liquidity is a major concern and indicated that permitting U.S. firms to sell foreign options to U.S. citizens would help in this regard. Mr. Davin also agreed that delivery problems are the single largest impediment to global trading. Chairman Shad also noted that settlement cycles vary among markets and fail rates are as high as 40% in some markets.

In response to a question from Commissioner Cox, Mr. Davin stated that one way in which the Commission could facilitate international linkages would be to approve the NASDAQ/SEAO 1/ linkage on a full pilot basis for two years, although Mr. Davin noted that the NASDAQ/SEAO linkage currently is of minimal value to professionals who have a complete array of information sources. He stated that he believed that the linkage could be of value, however, to institutional investors. Mr. Davin added

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1/ The "SEAO" system is the Stock Exchange Automated Quotation system of the ISE implemented on October 27, 1986, as part of Big Bang. It is a quotation collection system similar to NASDAQ.

that the linkage may have contributed somewhat to the growth in volume in U.K. American Depositary Receipts ("ADRs") and again urged Commission approval of a two-year pilot that would provide the Commission more data to assess the experiment. Mr. Knight [The International Stock Exchange of the U.K. and the Republic of Ireland, Ltd. ("ISE")] agreed with Mr. Davin's remarks.

Chairman Shad then introduced the next topic, international sharing of surveillance and other information. Mr. Leibler [American Stock Exchange ("Amex")] and Mr. Oyens (Amsterdam Stock Exchange) were the speakers on this topic.

Mr. Leibler stated that Amex's experience had been that foreign markets are willing to share most routine information needed for market surveillance but were concerned about disclosing customers' identities. Countries such as Canada, however, which share a common legal and cultural background with the U.S., are less reluctant to agree to share such information, as evidenced by the Amex-Toronto Stock Exchange information sharing agreement and the Ontario Securities Commission and Commission correspondence on Canada's blocking statute.

Other jurisdictions, particularly those with legal restrictions on disclosure of confidential customer information, are more reluctant to negotiate agreements. The European Options Exchange ("EOE") recently reached an information sharing agreement with Amex, however, by changing its by-laws to require its members to agree to allow EOE to share customer information with Amex.

Mr. Leibler added that the Commission should continue to encourage the development of common standards of conduct, for example, that insider trading is improper. Further, Mr. Leibler emphasized that the Commission should continue to negotiate agreements with foreign authorities. Mr. Leibler also stated that U.S. markets should continue to establish trading linkage agreements with foreign markets that provide for information sharing. He concluded by recommending that the Commission encourage foreign participation in intermarket surveillance groups and the formation of international intermarket surveillance groups.

Mr. Oyens agreed with Mr. Leibler's remarks on information sharing and added that regulators should not seek one harmonized global regulatory system. Rather, exchanges should create generally accepted principles of trading and regulators should then coordinate and cooperate on enforcement.

Commissioner Grundfest agreed with Mr. Oyens, stating that the long-term goal is structuring a cooperative environment in which each trading partner recognizes the legitimate interests of other trading partners in preventing the use of their domestic markets for the evasion of their trading partner's domestic laws, while each partner seeks not to impose its own unique views on its sovereign trading partners.

Chairman Shad then introduced the next topic: international market information. Mr. Knight and Mr. Davin were the commentators

on this topic. Mr. Knight stated that his exchange had reorganized itself under the new securities laws in the U.K. As part of that reorganization it is developing a regulated foreign equity market which will enable trading in widely held, liquid non-U.K. securities and that will have, in time, trade and volume reporting.

Mr. Davin took this opportunity to repeat that Commission approval of the NASDAQ/SEAO quotation link on a two-year pilot basis would be desirable. Mr. Davin then indicated that the benefits of internationalization were profound, including greater liquidity and broader dissemination of market information from major markets. Mr. Davin warned of four areas that needed to be addressed: (1) exchange of information among marketplaces and regulators; (2) facilitation of global delivery; (3) avoidance of the piecemeal initiation of rulemaking in the absence of substantive experience; and (4) the presence of cultural differences among markets and differences between unsophisticated and institutional investors. Chairman Shad agreed that differences in levels of sophistication should be considered. Furthermore, Chairman Shad stated that he believes that since international markets appear to be largely institutional markets, the question is whether to develop regulations that might diminish the efficiency of these markets for the benefit of small investors who are such a small segment of the market.

Mr. Ketchum next addressed a question to Mr. Knight.

In response, Mr. Knight stated that the ISE intends to develop a marketplace for trading of U.S. and other non-U.K. securities both during and after U.S. trading hours. Mr. Knight reiterated his earlier remarks that this market would be regulated and visible.

In response to a question from Commissioner Grundfest, Mr. Knight then indicated that the trading of U.S. securities in Europe is largely inter-professional, and, as such, is unlikely to be "refugee trading," i.e., trading occurring abroad to avoid U.S. restrictions. Mr. Knight acknowledged, however, that some U.S. banks trade in London because they cannot do so in the U.S. under the Glass-Steagall Act.

The next topic introduced by Chairman Shad was international clearance and settlement. The commentators on this topic were Richard Myers (ISCC) and Mr. Knight. Mr. Myers stressed the necessity of developing efficient, coordinated, cross-border settlement capabilities. According to Mr. Myers, international dealers face a greatly increased risk that trading profits will become administrative losses, in the absence of efficient processing systems. He pointed to centralized clearing systems in many national markets and in the Eurobond markets as examples of one theoretical solution -- a single global clearing system or

set of standards. Mr. Myers noted that as a first step, national clearance and settlement systems have begun to link with each other providing their participants with the ability to operate within, and not outside national markets. As an example, Mr. Myers noted ISCC's link with the ISE settlement system. The link has enabled ISCC participants to clear trades on a par with ISE members as dealers, not customers. Mr. Myers stated that he believes that there should be an active international clearance and settlement capability by the end of 1987 or early 1988. Mr. Meyjes agreed with Mr. Myers that the goal of national clearance and settlement systems must be to forge sophisticated and operationally viable links.

Mr. Knight commented on difficulties the International Federation of Stock Exchanges encountered 20 years ago when it tackled the subject of achieving greater cooperation among European clearance and settlement systems. In particular, Mr. Knight referred to the "legal impossibility" of admitting non-national members to national clearing systems. Mr. Knight stated that he believes that progress has been made on this issue, however, and cited the link with ISCC as an example. He also mentioned that the ISE successfully has negotiated links with France, Spain, South Africa, Germany, Australia and Japan.

In response to a question from Commissioner Peters, Mr. Myers expressed the view that the Commission's current approach to reviewing linkages between U.S. and foreign clearance and settlement systems on a "no-action" basis should be continued. He believes this approach: (1) encourages in-depth examination of the issues from the perspective of both parties to the link; and (2) makes publicly available the Commission's policies on the development of international clearance and settlement linkages. Mr. Knight also favored the no-action approach, emphasizing the importance of working with the staff on a case-by-case basis. Mr. Davin also encouraged the Commission to continue its reactive approach to the issue of international clearance and settlement. He believes that industry, in the first instance, should be given the opportunity to attempt to solve international clearance and settlement problems.

In response to a question from Commissioner Peters, Mr. Meyjes stated that settlement problems are systemic rather than regulatory, largely resulting from 20 different major markets with different settlement practices. Mr. Meyjes also indicated that, to some extent, the problem is self-correcting. He stated his belief that markets that do not improve their clearance and settlement systems will lose market share because investors will desert markets where the cost of settlement exceeds the

investment benefits of the securities. Mr. Meyjes said that these competitive forces already are promoting improvements.

The discussion next turned to whether regulatory adaptations are necessary to prevent trading volume from moving offshore to avoid domestic regulation perceived as more restrictive than that in foreign markets. Mr. Birnbaum (NYSE) commented first. Mr. Birnbaum cautioned against undercutting a regulatory framework that makes U.S. markets fair and equitable for all participants in the quest for more competitive markets. Mr. Birnbaum used the short-sale rule as an example, suggesting that some change to the rule would be beneficial to discourage traders from going to other jurisdictions without short-sale rules. He believes, however, that the solution must not compromise the rule's regulatory rationale.

Mr. Liftin (Quadrex Securities, Inc.) also commented on whether regulatory adaptations are necessary. Mr. Liftin stated his belief that offshore trading may occur to avoid insider trading rules, the NASD mark-up policy and, of course, off-board trading restrictions. Although Mr. Liftin commended the Commission and the NYSE for their willingness to re-examine their trading rules, he cautioned against a "competition in laxity." He agreed with a comment by Mr. Oyens that such a loosening of trading rules would risk approaching the lowest common denominator

among all the different markets. Furthermore, he believes that foreign investors, in fact, prefer to trade U.S. securities in U.S. markets, perceiving them as fair and equitable. Mr. Knight agreed with this observation.

Commissioner Grundfest echoed Mr. Liftin's statements that the level of regulation in a market defines the quality of the market. The Commissioner, using as an example insider trading, stated that he believes that the higher risk that a securities purchaser will end up on the "wrong side of an insider trading transaction in markets without insider trading protections, is reflected in the price of the security."

Mr. Davin suggested to the panel that a more innocent motive compels many traders to trade offshore and that time differences account for a great deal of such trading. He contends, for example, that it is obviously unrealistic for Japanese traders to stay in their offices until the middle of the night to trade U.S. securities on the NYSE or the Amex when they are open.

Mr. Leibler raised the question of whether the Commission should permit U.S. exchanges to revise their foreign listing standards. He stated that he believes that adaptation of these standards would enhance U.S. exchanges' competitiveness. Mr. Birnbaum agreed, stating that American investors are now buying foreign securities outside the U.S. that may not meet U.S.

listing standards. He therefore believes that permitting U.S. exchanges to adapt foreign listing standards will make the exchanges more competitive without increased risk to U.S. investors.

Mr. Birnbaum also was asked to comment on whether the proliferation of international affiliates complicates the NYSE's efforts to ensure the financial responsibility of its member firms. Mr. Birnbaum expressed great concern over the issue. He stated that the primary problem is the exchange's lack of authority to routinely examine the activities of foreign affiliates. Potential solutions Mr. Birnbaum identified include:

- (1) forging agreements among governments on the disclosure of relevant surveillance and financial responsibility information;
- (2) adopting uniform financial reporting and accounting standards;
- and (3) working toward eliminating the obstacles that blocking statutes create.

The final topic for the morning session of the Roundtable was barriers to entry into non-domestic markets. Mr. Fernandez spoke first on the difficulties non-U.S. firms face in attempting to break into U.S. markets. Mr. Fernandez seemed to believe that the most formidable "barrier" is a subtle one: a lack of clarity in the laws and regulations governing the activities in which foreign firms may engage. Mr. Fernandez pointed to what he considers "grey areas" in the Commission's policies on what foreign securities can be traded in the U.S. and when they may be traded. He believes that substantial questions remain on

seasoning requirements for stocks, the ability of U.S. investors to exercise rights or warrants on Japanese securities, private placements, and off-board and after-hours trading of exchange-listed securities.

Mr. Meyjes spoke from the perspective of a U.S. firm attempting to establish a competitive position in non-U.S. markets. He stated that, particularly in the last several months, substantial inroads have been made on several fronts. For example, he cited the recent loosening of restrictions on foreign firm participation in Ontario and Singapore. He also noted that the highly regulated French markets recently have given some indication that they are moving to liberalize their markets. He noted, however, that there are also subtle barriers to entry in the form of custom and "competitive behavior." As an example, he mentioned the difficulty a U.S. firm experiences gaining access to foreign underwriting syndicates, particularly in Japan.

Mr. Davin also applauded the recent deregulatory moves in many countries that are easing barriers to entry into their markets. He also suggested that the next step might be to link broker-dealer organizations internationally through the international clearing organizations.

Mr. Liftin commented on what he termed "self-imposed" barriers to entry in the Euromarkets. He cited Euromarket

participants' reluctance to deal with firms whose financial capability is not proven to them, and to the Euromarket clearing entities, Cedel and Euroclear, whom, he believes, have extraordinarily high financial standards for member firms. He also believes that Euromarket participants insist on dealing with firms with a reputation for being highly professional.

Mr. Liftin agreed with Mr. Meyjes that many barriers to entry are indeed cultural. He cautioned against the U.S. conditioning access to non-U.S. firms, however, on reciprocal treatment from the foreign country. He believes that the cost to U.S. markets of excluding foreign participants would be decreased liquidity in U.S. markets and would not outweigh the benefits of compelling some foreign markets to grant access to U.S. firms.

Richard Ketchum next summarized the morning's discussion. He identified areas of consensus as: (1) the existence, for at least institutional trading, of a 24-hour market; (2) the continued pre-eminence of the home market for customer activity and necessary liquidity; (3) the need to further develop international clearance and settlement mechanisms; (4) the necessity of intergovernmental and self-regulatory information and surveillance sharing agreements; (5) the need to develop methods to disseminate market information, both quotes and last sale information; and (6) the desirability of the Commission's reactive approach to dealing with developments in the internationalization arena.

Chairman Shad concluded the session by emphasizing his agreement with the notion that the Commission should let the internationalization of the world's securities markets occur without undue interference from regulators. He also took the opportunity to praise the recent successful negotiations on obtaining information sharing agreements.

Five key areas were the focus of the afternoon session: offerings of securities abroad; "flowback" into the United States; creation of a "free trade zone" for institutional trading of unregistered securities; restrictions on distribution participants in international offerings; and foreign broker-dealer activity in the United States.

The first question raised was the appropriate reach, if any, of the Securities Act registration process to offshore financings. Edward Greene (Cleary, Gottlieb, Steen & Hamilton) began the discussion by summarizing the purposes of Securities Act Release No. 4708, which permits a foreign offering to be made using jurisdictional means without registration provided the distribution is done abroad. He said the release was promulgated because the U.S. securities laws were primarily designed to protect U.S. persons, a term that probably includes both nationals, wherever located, and residents. He noted that procedures followed to assure securities come to rest abroad pursuant to the release have developed through the "no-action" process and that, given the growing interest in securities

denominated in other currencies and issued by issuers in other countries, the current structure needs to be revisited, particularly the reach of the Securities Act. His view was that the Act should apply to offers and sales in the United States only and should not apply to offers and sales outside the United States by any issuer, U.S. or non-U.S., to nonresidents of the United States. He also expressed the view that corporate, insurance company, and bank branches operating in a jurisdiction abroad where they are regulated should be treated as nonresidents. He believed transactions with foreign-based investment advisors or fiduciaries should be treated as nonresident transactions if those advisors are acting with discretion and that, if the sale is made offshore to a foreign advisor with discretion, the transaction should not be subject to the Securities Act even if the beneficiary is a U.S. entity. He suggested that international banking facilities be carved out and that a targeted offering at offshore persons such as U.S. armed forces personnel should be subject to the Securities Act. He said that a territorial approach does not mean we have to be insensitive to flowback, but it need not be as elaborate as at present. He further said that it would be a mistake to impose Exchange Act reporting requirements on issuers simply because their securities flow into the United States unless the issuers have taken voluntary steps to enter the United States.

Neal Garonzik (Morgan Stanley) then identified certain major problem areas: (1) the anomaly between the lack of Exchange Act protection U.S. investors receive when they go offshore and that which is mandated under the Securities Act; (2) the need to keep our capital markets and participants competitive while preserving the quality of our markets; (3) the question of who is protected under the U.S. laws; and (4) practical problems of implementation because of the "fungibility of securities in a world of electronic clearance mechanisms." He advocated continued encouragement by the Commission of its counterparts in principal overseas markets to adopt more stringent disclosure standards, an exemption from registration for sales to institutions, varying holding periods after which securities may be sold into the United States for different classes of investors, differentiation between issuers who are Exchange Act reporters and those who are not, and differentiation between investment grade bond issues and lower-rated securities and between common stock and convertible bonds.

After discussion, Commissioner Grundfest noted the consensus of the group that the Securities Act imposes some artificial impediments and costs on operation of the markets with minimal benefits. Commissioner Fleischman qualified that the consensus applies to initial public offerings. Mr. Greene stated there is also a consensus that some flowback restrictions are required to prevent evasion of the Securities Act, but the present ones

are too extensive and costly. He also expressed the view that one error in the distribution procedure should not cause the entire offering to be in violation of the Securities Act.

Mr. Greene and William Williams (Sullivan & Cromwell) then discussed with Commissioner Fleischman and Chairman Shad drawing a "bright line" for a flowback time and whether a pre-existing market in the United States should make a difference. The discussion was inconclusive, but Mr. Williams stated that caution must be taken when drawing lines based on the state of the market at the time the resale is made, which would be a moving target. He also suggested it would be a mistake to set an objective time period in excess of six months.

Moving ahead on the agenda, Commissioner Peters and Mr. Greene then discussed the appropriate definition of institutions, if a distinction is made between resales to institutions and others of securities initially sold abroad without registration. Mr. Greene said that the obvious core would be mutual funds, pension funds and insurance companies and beyond that banks and financial institutions should probably be included. It was agreed that individuals should be excluded initially.

A discussion followed regarding the change in disclosure and resulting lack of comparability that would occur if institutions were allowed to "fend for themselves." Mr. Greene expressed the view that this is not a problem in the debt market because of rating agencies. It remains a problem with common stock, however, in that if compliance with the Securities Act is required, the issuers will not sell in the United States.

In summary, with respect to the first issue, a consensus was reached that a territorial approach to application of the Securities Act is needed. It was agreed that offers and sales within the United States, including offers and sales to foreigners temporarily present in the U.S., should be protected, and that offers and sales to U.S. citizens residing abroad should not be protected. No consensus was reached on whether offers and sales to U.S. residents who purchase in overseas markets should be protected. Participants left open the question of how to define the location of an offer or sale, a particularly important question when orders are placed telephonically. Also unresolved was how to protect against offerings targeted to the United States through foreign markets. It was generally agreed, however, that such protections must be provided if a territorial approach is adopted.

The next issue was then formally addressed: "If offshore sales are limited in some fashion, what would be the effect of creating a 'free trade zone' for institutional trading of unregistered securities"?

John Mayer (Morgan Guaranty Trust Company) noted that, particularly in equity issues, most trading has migrated back to the home market for liquidity.

Mr. Williams then described the "free trade zone" concept as an exemption from the registration requirements of the Securities Act for offers and sales by the issuer to institutional

accredited investors and resales by those institutions to other institutional accredited investors. He suggested that it could supplant a significant portion of shelf-registered debt issues and that the question is whether there would be limitations, such as eligible issuers (those registered under the Exchange Act) or eligible securities (debt only, or investment grade only). Mr. Williams commented that primary sales abroad cannot be limited to institutions because the Euromarket includes individuals. In terms of resales, he recommended permitting such sales after some relatively brief period into an organized trading market abroad without inquiry as to the buyer, at least in the case of equity securities sold on a bona fide exchange. He also believed that any such exemption should allow resales into the United States for securities of qualified issuers at any time.

Peter Clapman [College Retirement Equities Fund ("CREF")] stated that CREF was losing millions of dollars as a result of regulation, particularly because U.S. persons are excluded from foreign rights offerings and that the idea of an institutional market is an appropriate way to reduce prejudice to American investors and not jeopardize regulatory responsibilities.

Mr. Greene expressed his view that the 4(1-1/2) exemption is sufficient in the debt market but, with respect to the equity markets, he may have concerns if tacking is permitted and at some point securities can leak into the U.S. market where appropriate information is not provided.

Charles Whitman (Davis, Polk & Wardwell) said that the "clear word you are hearing is that if you don't change your rules, you are exporting the market and that's a bad idea."

With respect to the type of securities that could be sold under such an exemption, Mr. Williams stated that a limitation of the exemption to reporting companies and investment grade debt substantially ignores foreign securities and that there should be no concern if it is opened up to equity securities.

A concern was expressed, however, by another participant that a two-price market may result for domestic equity securities, though in the international arena, arbitrage might decrease the price differential between the foreign market and the U.S. market.

The third area, the ability of foreign companies to undertake public offerings in the United States, was then addressed. Douglas Hawes (LeBeouf, Lamb, Leiby & McCrae) stated his approval of a reciprocal approach initially on a limited basis of the debt of certain world-class issuers. He then said that the reason foreign companies do not enter U.S. markets is the liability issue and fear of the SEC and unknown changes. He said the accounting and disclosure issues are minor. He recommended a mechanism whereby foreign companies who register in the United States would not have to comply with any new requirements for a period of time, during which they could extricate themselves from jurisdiction.

David Meachin (Merrill Lynch Capital Markets) commented that the reciprocal prospectus may be important for large quality corporate issuers that do rights offerings, particularly to provide direct access to the issue by individuals and expressed his approval of the free trade zone concept. He also suggested that because offerings made concurrently in different jurisdictions may be expected to become more prevalent, the Commission should focus on facilitating timing of these issues prior to marketing. He also commented that abiding by Commission rules regarding publication of research material puts U.S. broker-dealers behind foreign broker-dealers.

John Liftin (Quadrex Securities Corporation) stated that it would be an error to minimize the difficulty for foreign issuers of complying with SEC accounting and disclosure requirements, focusing on the problem of segment reporting. He also addressed the rights offering problem and recommended that rights issues be permitted, provided there is no distribution or selling effort.

Mr. Knight added that rights offerings remain a convention in many parts of the world but noted that the U.K. has eliminated the strictest of its preemptive rights requirements. There was then a discussion of the fairness of treating foreigners leniently and exporting U.S. capital. Mr. Meachin stated that capital is already exported through foreign secondary markets and will continue to be exported one way or another.

Following was a discussion of whether the reciprocal approach would be used, if available. Mr. Greene expressed the view that, because of liability, if alternatives are available, they will be used. Mr. Williams raised the concern of liability in reciprocal prospectuses that permit omission of information required by U.S. issuers. Linda Quinn, Director, Division of Corporation Finance, stated the form could specify that no more disclosure is required and added that equity securities across the board would probably not be included. Mr. Meachin stated his view that even for equity, world-class issuers should be included in the reciprocal approach.

The Chairman then introduced the discussion of Rules 10b-6 and 10b-7 under the Exchange Act. Mr. Whitman commented that the staff of the Commission has been very responsive to issues under Rules 10b-6 and 10b-7 in international offerings. Mr. Whitman stated that, in the past, Rule 10b-6 was applied to foreign portions of U.S. offerings even though foreign underwriters were not aware that they were subject to Rule 10b-6.

Mr. Whitman stated that foreign markets differ from U.S. markets, and he maintained that imposing on foreign underwriters U.S. rules that restrict various market participants from buying securities where there is a U.S. tranche of an offering, because such purchases might have an effect on raising the price of the security in the foreign market, might serve to reduce the

chances of any U.S. offering of foreign issues. Mr. Whitman stated that the staff had tailored no-action letters under Rule 10b-6 to reflect the realities of the international markets and referred specifically to recent multinational securities offerings of British and French companies.

Finally, Mr. Whitman said that prior to "Big Bang," the underwriters in a British offering could represent that they would not buy for their own accounts to facilitate market transactions. Because "Big Bang" permitted underwriters to become affiliated with "jobbers" and brokers, they can no longer make those same representations. He noted that on an oral basis the Commission staff has permitted the same representation to apply, taking into account British firms' Chinese Walls between their underwriting and trading facilities.

Gregory Sacco (Shearson Lehman Brothers, Inc.) observed a proliferation of U.S. issuers doing simultaneous domestic and European tranches. He thought this was beneficial and has brought investor interest in securities on a primary placement basis as well as in the aftermarket. In such offerings, he said it is a settled practice that non-U.S. syndicate participants defer to U.S. regulations, and defer to U.S. underwriters to execute Rule 10b-7-related transactions.

Mr. Garonzik said that he found the European market much more acclimated to bond issues which are often sold on a variable

price basis. He also suggested that even though non-U.S. firms were content to leave Rule 10b-7 matters to managing underwriters, as a practical matter he thought there were frequently unwitting violations of Rule 10b-6 in fixed price equity offerings. This is so because the purchasers pay different prices for such securities without disclosure of that phenomenon. He was not confident that managing underwriters could do adequate policing of this matter.

Mr. Williams suggested that where the principal trading market is in the U.S., the rules should apply just to the U.S. market and should not be applied offshore. He suspected that it was difficult, inefficient, and uneconomic to manipulate the stock of a number of U.S. issuers by transactions in that stock abroad and relying on arbitrage to affect the U.S. market. Mr. Whitman responded that if the Europeans nevertheless choose to engage in such trading it will have the manipulative effect that Rule 10b-6 was designed to prevent. Mr. Davin agreed with Mr. William's assessment and said that he would favor an exception from Rule 10b-6 where the portion of the offering abroad is de minimis relative to the U.S. portion; for example, under 20% of the overall offering. With respect to foreign issuers offering securities in the U.S., however, Mr. Williams said that manipulation of the issuer's price in its home market would have a direct impact on the price of the security in the U.S.

The Chairman inquired as to whether there would be arbitrage opportunities and Mr. Garonzik said there would be. In addition, Mr. Ketchum thought that there is flowback going back and forth daily between U.S. and foreign markets in U.S. securities. He inquired as to why that buying activity in the foreign market would not flow back into layoffs in the U.S. Mr. Davin suggested that the flowback problem might be exaggerated.

The Chairman asked Mr. Ketchum whether there was any evidence of abuse in this area. Mr. Ketchum responded that Rule 10b-6 serves as a deterrent so it is difficult to measure abuse. Mr. Ketchum asked whether there was any difference in the likelihood of manipulation through arbitrage or flowback in larger issues with large public floats or with respect to smaller, more speculative issues. Mr. Williams maintained that small U.S. issuers would not have significant foreign trading markets, and that it was unlikely there would be price manipulation in such securities by transactions outside the U.S. He apparently believed that the securities of a NYSE-listed issuer could be manipulated in London after trading had ended for the day in the U.S.

The final session focused on U.S. broker-dealer activity abroad and efforts by foreign broker-dealers to enter the U.S. markets. The first commentator was Charles Whitman. Mr. Whitman initially discussed the effect that linkages have had in requiring the Commission to permit foreign entities to provide at least

quote information in the U.S. without registering as broker-dealers. He acknowledged that the staff seems to have backed away from its previously outstanding position prohibiting dissemination of research in the U.S. by a foreign entity and now permits research to be disseminated in the U.S. if a registered U.S. broker-dealer assumes responsibility for the information provided.

Mr. Whitman then discussed the fact that most U.S. broker-dealers conduct their foreign business through foreign-based affiliates that are not registered in the U.S. as broker-dealers. In his view, although the foreign affiliates could be seen as doing business in the U.S., the parent broker-dealer's registration thus far has precluded questions as to whether the foreign affiliates should themselves register as broker-dealers. He questioned whether a U.S. broker-dealer should be permitted to shield its foreign subsidiary from the broker-dealer registration requirements if the subsidiary engages in business in the U.S. He continued this line of thinking by asking whether foreign entities with U.S.-registered affiliates should be required to register if their business overlaps into the U.S. Mr. Whitman suggested that U.S. registration was not necessary for foreign-domiciled entities because the Commission had access to the entities and their activities through the shingle theory.

The second commentator was James Davin (First Boston Corporation). Mr. Davin discussed broker-dealer issues very

briefly and then moved to other issues. With regard to broker-dealer registration, he noted his view that as long as the activities of foreign broker-dealers in the U.S. are limited to dealings with other broker-dealers, and other sophisticated institutions, broker-dealer registration is unnecessary. He considers, however, broker-dealer registration necessary if a foreign entity is engaged in a full-service securities business.

At the conclusion of these comments, Mr. Ketchum questioned how the U.S. could adequately ensure against the movement of U.S.-barred persons from U.S. entities to their foreign affiliates. He asked whether this concern might be alleviated by treatment of the personnel of foreign affiliates as associated persons of the U.S. entities. Mr. Whitman responded to Mr. Ketchum's concerns by agreeing that a "front man" doing business in the U.S. for a foreign entity would defeat the purposes underlying the broker-dealer registration requirement. Mr. Whitman expressed the view, however, that a foreign entity not doing business in the U.S., or legitimately directing business through a U.S.-registered broker-dealer, should not be subject to the Commission's jurisdiction, absent misdeeds involving U.S. jurisdiction. Mr. Ketchum also asked whether U.S. affiliates of foreign broker-dealers should be required to be involved in all aspects of a foreign parent's sales activities in the U.S. Mr. Whitman responded to this question by noting that, at present, foreign entities send sales personnel to the U.S., but all sales efforts are made in conjunction with, and in the presence of, representatives of the U.S.-registered affiliate.

The final commentator, William Wilby (AIG Global Investors), discussed management of international funds. He noted that in managing an international fund, performance is weighed against a non-U.S. index, with most returns resulting from successful selection of markets, rather than instruments. He listed several factors that are assessed in determining whether or not to invest in a particular market, including politics, interest rates, local investing patterns and various market risks. Mr. Wilby expressed the view that individual investors may not be able to diversify away risks in the international markets, but institutional investors are able to do so.

At the end of the afternoon session, Ms. Quinn summarized the Division of Corporation Finance issues as follows:

1. There was overwhelming endorsement of the territoriality approach; offshore sales of reporting companies would require some protection against flowback; offshore affiliates and other institutions, onshore and offshore, could buy foreign securities without registration; there was some sentiment for allowing offshore sales be made to U.S. residents, but the question of how to define the locus of the offer and sale was not addressed.

2. There was sentiment that flowback protections need to be simplified; holding periods defined and preferably shortened and a distinction between convertible securities and common stock.

3. With respect to the institutional free trade zone, there was a consensus that it is a great idea but as yet is undefined and unclear as to whether it should be limited to certain classes of securities or classes of issuers. The problem of two-tier pricing was raised and any free trade zone should be done in tandem with revision of Release No. 4708.

4. Resales onto established secondary trading markets by institutions taking in private placements must be permitted.

5. With respect to reciprocity, there was widespread endorsement but substantial skepticism as to whether this approach would in fact be used by many issuers. There were fears of the SEC, Congressional legislation and liability and a suggestion that timing risks be reduced. There was also a question about research reports for U.S. brokers where foreign brokers are unregulated.

6. The need to address the problem of disparity between foreign and domestic issuers was also raised.

Mr. Ketchum concluded the afternoon session by recapping the discussion on Rules 10b-6 and 10b-7 and on foreign broker-dealer registration. Mr. Ketchum stated that the panel generally agreed that the Commission has shown adequate flexibility in applying Rules 10b-6 and 10b-7 where the primary market for a distribution exists abroad. Mr. Ketchum noted that the panel was not agreed on whether the Rules should be applied to foreign trading where the primary market was in the U.S.

The panel split on the question of foreign broker-dealer registration. Mr. Ketchum noted that some panelists believed registration should not be required of foreign broker-dealers who disseminate research in the U.S. as long as a registered U.S. broker-dealer assumes responsibility for the information provided. Mr. Ketchum also noted that some panel members believed that non-registration of foreign broker-dealers conducting these activities gave them an unfair competitive advantage over their U.S. counterparts and believed that they should be required to register if their selling activities extended to customers other than broker-dealers and banks.

Chairman Shad next asked Gary Lynch, Director, Division of Enforcement, if he had any comments on the day's discussion. In response, Mr. Lynch remarked that he agreed with earlier commentators on the importance of information sharing arrangements and regulator access to customer information.

Chairman Shad then thanked the participants and concluded the session.

**Attachment A**

Briefing Memorandum

Internationalization Roundtable  
Participants and Discussion Topics

The Internationalization Roundtable to be held at the Commission on February 17, 1987, will be divided into a morning and an afternoon session. The morning panel will discuss secondary market and clearance and settlement issues and the afternoon panel will discuss primary offering issues. The participants in each panel will be:

**Morning Session: Secondary Market Issues**

Kenneth R. Leibler, President  
American Stock Exchange, Inc.

Gerrit de Marez Oyens, Secretary General  
Amsterdam Stock Exchange

C. Robert P. Meyjes, Senior Vice President  
Citicorp Investment Bank

Richard W. Myers, Senior Vice President, Operations  
International Securities Clearance Corporation

Jeffrey Knight, Chief Executive  
International Stock Exchange of the United Kingdom  
and the Republic of Ireland, Ltd.

James M. Davin, Vice Chairman, Finance  
National Association of Securities Dealers, Inc.

Robert J. Birnbaum, President  
New York Stock Exchange, Inc.

Brian Fernandez, Senior Vice President  
Nomura Securities International Inc.

John M. Liftin, President  
Quadrex Securities Corporation

Donald Unruh, Vice President  
Toronto Stock Exchange

**Afternoon Session: Primary Offerings**

William L. Wilby, Managing Director  
AIG Global Investors

Gerrit de Marez Oyens, Secretary General  
Amsterdam Stock Exchange

Edward F. Greene  
Cleary, Gottlieb, Steen & Hamilton

Charles S. Whitman, III  
Davis, Polk & Wardwell

James M. Davin, Managing Director  
First Boston Corporation

Jeffrey Knight, Chief Executive  
The International Stock Exchange of the United Kingdom  
and the Republic of Ireland, Ltd.

Douglas W. Hawes  
LeBoeuf, Lamb, Leiby & MacRae

Roderick M. Hills, Chairman and Managing Director  
The Manchester Group Ltd.

David J.B. Meachin, Managing Director  
Merrill Lynch Capital Markets

John A. Mayer, Jr., Senior Vice President  
Morgan Guaranty Trust Company

Neal S. Garonzik, Managing Director  
Morgan Stanley & Co., Inc.

Peter C. Clapman, Senior Vice President and  
Associate General Counsel  
Teachers Insurance and Annuity Association/College  
Retirement Equities Fund

Gregory Sacco, Jr., Executive Vice President  
Shearson Lehman Bros., Inc.

William J. Williams, Jr.  
Sullivan & Cromwell

I. MORNING SESSION

A. International Secondary Market Trading Mechanisms

The bulk of transnational secondary market securities transactions currently occurs in an over-the-counter environment, principally between large dealers and institutions trading over the telephone or via other telecommunications systems. Intermarket trading linkages, however, have been established in the last two years, including: (1) the American ("Amex") and Toronto Stock Exchanges ("TSE") link; (2) the Boston and Montreal Stock Exchanges link; and (3) the TSE and Midwest Stock Exchange link. The National Association of Securities Dealers ("NASD") and International Stock Exchange of the United Kingdom ("U.K.") and the Republic of Ireland ("SE") also have implemented a quotation exchange mechanism. Agreements in principle have been reached between the SE and the Philadelphia Stock Exchange and the Amex and European

Options Exchange to trade fungible options contracts in foreign currency and index options, respectively. Finally, TSE officials have suggested the development of an alternative market structure, which could include the consolidation of trading in a single central limit order book in the home market of internationally traded issues.

The Commission is interested in discussing:

- the mechanics and utility of these different transnational trading systems;
- the benefits and risks of the rapidly increasing internationalization of the securities markets;
- likely future developments;
- problems anticipated in further linkages of the markets; and
- other steps that might be taken, similar to the Intermarket Surveillance Group.

#### B. Information Sharing Agreements

As a part of the Canadian/U.S. market linkages, and in other contexts, the Commission and various foreign government agencies have developed bilateral agreements for the routine exchange of surveillance information and the provision of mutual investigatory assistance. See attached Division of Enforcement Memorandum describing these agreements. Similarly, marketplaces entering into linkage arrangements have executed information exchange agreements. One of the major concerns in developing these agreements has been the Commission's need to obtain evidence and other information relevant to the enforcement of the U.S. securities laws. As described in the attached Division of Enforcement Memorandum, the Commission also has worked on the development of multilateral accords in this area. The Commission is interested in discussing the existing agreements and any experience to date under these agreements. These questions also arise:

- What are the principal legal issues and impediments (e.g., blocking statutes and secrecy laws) affecting the transnational exchange of information?
- What bilateral and multilateral agreements should be developed in the future?
- What should be the nature of these agreements?

C. Market Information

The availability of market information (quotations, last sale prices and volume) in the various major international markets differs. Furthermore, aside from the internal telecommunications systems of broker-dealers, there is no facility for consolidating on a global basis the information that is available regarding securities that trade in more than one national market.

The Commission is interested in discussing:

- the differing practices in the major international markets in regard to dissemination of quotations, last sale and volume reporting;
- the systems broker-dealers use to collect and consolidate information; and
- the prospects and problems of global market information consolidation.

D. International Clearance and Settlement

The largely manual clearance and settlement systems of some markets, as well as the lack of adequate transnational clearance and settlement mechanisms, remains one of the major obstacles to the development of international secondary trading markets. The Commission has approved several clearance and settlement linkages (e.g., the links between the Midwest Clearing Corporation/Midwest Securities Trust Company, the Canadian Depository for Securities ("CDS"), the Vancouver Stock Exchange Services Corporation and the SE, and between the National Securities Clearing Corporation ("NSCC") and CDS). Also, NSCC has formed the International Securities Clearing Corporation to facilitate international clearance and settlement linkages. The bulk of transnational trades, however, still settle outside of organized clearance systems, largely via Telex and physical deliveries of certificates.

The Commission is interested in discussing:

- clearance and settlement problems and the steps the Commission and the industry can take to accelerate progress in this area;
- the standards for foreign membership in a U.S. clearing agency;
- whether clearing agencies should be permitted to rely on foreign financial responsibility standards in ensuring the credit worthiness of a foreign member;

- how U.S. clearing agencies should assure the financial responsibility of linked clearing agencies and their members; and
- whether responsible government agencies should attempt to reach a multilateral agreement on minimum clearance and settlement standards for active trading markets.

#### E. Regulatory Adaptations

The proliferation of active international securities affiliates of U.S. broker-dealers (and active U.S. securities affiliates of foreign broker-dealers) arguably has complicated for regulators in each country the job of enforcing their rules and monitoring the financial responsibility of their registered broker-dealers. In addition, many of the increasingly efficient and accessible foreign markets for U.S. securities have different rules and restrictions than the Commission or U.S. self-regulatory organizations ("SROs").

- Has the proliferation of international securities affiliates weakened the ability of any regulator to assure the financial responsibility of its securities markets?
- Should the Commission and the SROs adapt any of their rules (e.g., short sale rules) to the increasing internationalization of secondary markets?

#### F. Barriers to Entry

The federal securities laws provide for the national treatment of all broker-dealers, i.e., both foreign and U.S. broker-dealers are entitled to establish and operate securities businesses on equal terms. While much progress has been made in recent years in opening foreign markets to U.S. broker-dealers (e.g., the Tokyo Stock Exchange providing four seats to U.S. firms, and the U.K. and Canada opening up access to their markets to foreign broker-dealers); barriers to entry remain in some markets.

The Commission is interested in discussing:

- the progress made in this area;
- the particular barriers that remain and in which markets;
- what the Commission's role should be in eliminating such barriers.

II. AFTERNOON SESSION

A. Offerings of Securities Abroad, "Flowback" Into the United States and Creation of a "Free-Trade Zone" for Institutional Trading of Unregistered Securities

A 1964 Commission release (Securities Act Release No. 4708) stated that the Commission would not take enforcement action for failure to register under the Securities Act if a domestic issuer sold its securities abroad solely to foreign investors and the securities "came to rest" abroad. The increasing internationalization of the securities markets and regulatory changes since the Commission issued Release No. 4708 call for review of the concepts underlying the release.

1. What should be the reach, if any, of the Securities Act registration process to off-shore financings?

- Should it reach, as at present, to any offering to U.S. nationals or U.S. residents?
- Should it instead be limited to offerings in the U.S. capital markets (i.e., along geographic lines)?
- If so, how should geographic lines be drawn?
- As part of a geographic approach, should there be any restrictions on sales that are made to U.S. residents offshore?
- Should there be a distinction in any such approach between reporting and non-reporting issuers?
- If sales are permitted to U.S. residents in distributions abroad without flow-back restrictions, should it make a difference whether there was an established trading market for the securities of the issuer in the foreign market or in the U.S. prior to a distribution into the foreign market?
- If there were no restrictions on flowback, would the availability of the exemption provided foreign private issuers from registration under Section 12(g) of the Exchange Act pursuant to Rule 12g3-2(b) require reconsideration? If so, how would we enforce compliance with Section 12(g)?

- If sales could be made without restriction to U.S. residents abroad, would primary offerings be likely to be driven offshore?
  - If limitations should be placed on sales to U.S. residents or nationals, what should those limits be?
2. If offshore sales are limited in some fashion, what would be the effect of creating a "free-trade zone" for institutional trading of unregistered securities?
- What would the implications of such an approach be on established trading markets?
  - Would this approach increase the likelihood of primary offerings and secondary trading of foreign equities in the United States?
  - Should any such "free-trade zone" be restricted to certain types of securities (e.g., investment grade senior securities) or to the securities of reporting companies?
3. A related issue is the ability of foreign companies to undertake public offerings in the United States. A reciprocal approach, without any reconciliation to U.S. disclosure requirements, under which offering documents accepted in the home jurisdiction could be used in the United States for British and Canadian issuers is being explored for offerings of investment-grade debt by world-class issuers, and certain exchange and rights offerings.
- To what extent would a reciprocal approach encourage foreign issuers to sell securities in the United States?
  - Would an institutional free-trade zone result in minimal reliance on a reciprocal registration process or would it provide a valuable alternative to an institutional free trade zone, and in what cases?

B. Restrictions on Distribution Participants  
in International Offerings

Presently, no-action and exemption letters take the position that during a distribution of any security (debt or equity) with a market in the United States, market activities of distribution participants must be conducted in compliance with Rules 10b-6 (which prohibits, with certain exceptions, trading by persons interested in a distribution of securities) and 10b-7 (which governs stabilizing to facilitate a distribution of securities) under the Exchange Act unless an exception from those rules is available or exemptive or no-action relief is granted. (See, e.g., Letter regarding Louis Vuitton S.A. (June 21, 1984) and Letter regarding British Petroleum Company (September 15, 1983) with respect to Rule 10b-6; see Letter regarding Tricentrol Limited (July 2, 1980) with respect to Rule 10b-7. See also Securities Exchange Act Release No. 21958 (April 18, 1985) ("Release 34-21958"), where the Commission discussed the application of Rules 10b-6 and 10b-7 to international offerings.

Two commentators responding to Release 34-21958 opined that the case-by-case approach taken by the staff in the international distribution context had proven effective, but suggested that general guidelines or rule amendments be formulated to provide greater guidance as to the application of the rules. Other persons have recommended other approaches. In a number of international offerings, the foreign underwriting syndicates have included contractual provisions designed to achieve compliance with Rules 10b-6 and 10b-7.

Should a change be made in the basic concept of Rules 10b-6 and 10b-7 when applied to international offerings, or should the existing concept be streamlined and adapted to the present markets?

- Given the international character of the securities trading markets, can the application of the rules be limited by geographical boundaries, either with respect to the location of the distribution or the market activities of the distribution participants?
- Should it make a difference whether there is an established United States trading market for the issuer's securities? Does it make a difference if the United States does not have the primary market for the securities?
- If the rules should continue to apply to international offerings, should they be revised in any way to accommodate present syndicate practices abroad?

- ° Should the rules continue to apply to transactions in debt securities outside the United States?

C. Foreign Broker-Dealer Activity  
in the United States

Foreign entities wishing to conduct a securities business in the United States or with U.S. investors generally must comply with the Commission's broker-dealer registration requirements. However, the Commission, by exemptive order, and the Division of Market Regulation, by no-action letter, recently have indicated that foreign entities may participate in certain securities activities in the United States without broker-dealer registration, subject to specific limitations and conditions.

The Division of Market Regulation has granted temporary no-action positions to the SE two programs established to permit SE market makers to provide continuous quotations in the United States with respect to SE traded securities. Pursuant to both no-action letters, SE market makers may disseminate quotations, without themselves registering with the Commission. Both letters, however, expressly exclude from the scope of permissible activity direct solicitation of customers in the United States and provision of analytic or research reports, through any medium, to United States investors. Both no-action positions terminate on a specific date and are subject to reexamination by the Division.

In addition, the Commission has granted an exemption from broker-dealer registration to Vickers da Costa, Ltd., a U.K. market maker proposing to maintain continuous quotations in the United States through a U.S. registered affiliate, Vickers da Costa Securities, Inc. The exemptive order includes strict limitations on the nature and extent of securities activity in which the U.K. entity may engage in the United States. The exemptive order also conditions the United States affiliate's interaction with the U.K. affiliate and imposes conditions on the United States broker-dealer to ensure that all United States customers are adequately protected in transactions that involve the U.K. affiliate.

Discussion Questions

- Should foreign market makers that limit their contacts in the United States to disseminating quotations through established market systems be required to register with the Commission, or would a conditional no-action letter based on strict limitations on the nature and extent of the foreign entities' activities be sufficient to safeguard the interests of U.S. investors who choose to use the market makers' services?
- Should foreign market makers be permitted to provide research or investment reports in the United States in addition to their quotations through established market systems without registering as broker-dealers?
  - a) If customers are not solicited?
  - b) If individual customers are indirectly solicited?
  - c) If individual customers are directly solicited?
  - d) If the research is disseminated by a U.S. broker-dealer affiliate?
- Should foreign market makers be permitted to deal with United States investors if all U.S. transactions are routed through a registered U.S. broker-dealer? In particular, should the foreign broker-dealer have access to U.S. customers if representatives of the U.S. broker-dealer are present at all conversations and all U.S. investors are customers of the U.S. broker-dealer?
- Should the Commission consider moving toward a concept of reciprocity in evaluating no-action or exemptive requests?
- Should the Commission consider the propriety of negotiating reciprocity agreements or assessing the equivalency of regulation in the area of broker-dealer registration?
- Given the difficulties of obtaining legal jurisdiction over foreign entities, should obtaining this jurisdiction on behalf of the Commission and U.S. investors be a consideration in granting foreign broker-dealers relief from U.S. registration requirements?

Attachment: Division of Enforcement Memorandum on  
Information Sharing Agreements

MEMORANDUM

February 6, 1987

TO: Chairman Shad

FROM: Gary Lynch *AS*  
Director, Division of Enforcement

Michael D. Mann *Holl*  
Chief, Office of International Legal Assistance  
Division of Enforcement

RE: Roundtable Briefing Paper relating to Commission Efforts  
to Negotiate Information Sharing Agreements

This memorandum describes the various agreements which the SEC has available, or which are currently under negotiation, to obtain evidence from abroad as well as other multilateral initiatives which the SEC has underway.

I. Bilateral Agreements for Information Sharing

A. Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the U.K. Department of Trade and Industry

On September 23, 1986, the SEC and CFTC signed a Memorandum of Understanding ("MOU") with the United Kingdom Department of Trade and Industry ("DTI"). The MOU provides, on a reciprocal basis, the SEC and the DTI with assistance in obtaining records which are in the hands of the other or which can be obtained through voluntary cooperation. It is an interim arrangement which both parties see as a first step in their efforts to establish a comprehensive understanding to provide bilateral cooperation relating to securities regulation.

The MOU is available for use in investigations and regular market oversight. Specifically, the MOU makes assistance available in matters involving insider trading, market manipulation and misrepresentations relating to market transactions as well as in efforts relating to the oversight of the operation and financial qualifications of investment businesses and brokerage firms. The MOU will provide the CFTC with similar assistance.

The SEC and the DTI have already had numerous occasions to utilize the MOU.

B. Memorandum Between the U.S. Securities and Exchange Commission and the Securities Bureau of the Japanese Ministry of Finance

The SEC has also signed a memorandum with the Securities Bureau of the Japanese Ministry of Finance concerning the exchange of information relating to securities regulation and enforcement. In that Memorandum, signed on May 23, 1986, the agencies "agreed to facilitate each agency's respective requests for surveillance and investigatory information on a case-by-case basis." The Memorandum appointed a specific contact person in each agency to enhance regular communication and processing of requests. While the Memorandum is less specific than the MOU with the DTI, the SEC has used it to obtain information and is pleased with its operation.

C. Memorandum of Understanding Between the United States and Switzerland

On August 31, 1982, the governments of the United States and Switzerland signed a Memorandum of Understanding to establish "mutually acceptable means" for dealing with the problems of insider trading. The MOU mandates the establishment of a provisional arrangement for providing the Commission with assistance in the form of a separate private agreement among members of the Swiss Bankers' Association ("SBA"). That agreement, known as Convention XVI (the "Convention"), Convention XVI applies to insider trading which has occurred prior to announcement of an "acquisition" or "business combination," as those terms are defined in the agreement. The Convention requires the board of directors of the SBA to appoint a Commission of Inquiry to handle requests by the SEC. If the Commission of Inquiry is satisfied that the SEC has met certain thresholds set out by the Convention, the Commission of Inquiry will call for a report from the banks involved concerning the transactions covered by the request. Further, upon receipt of the request from the Commission of Inquiry, the bank will freeze the relevant customers' accounts up to the amount of the profit realized in the transaction. This assures that the funds at issue cannot be dissipated or secreted pending resolution of a case.

Convention XVI has been used successfully by the SEC. The SEC brought the first case based upon information received pursuant to the Convention in August 1986.

D. Treaty Between the U.S. and Switzerland  
on Mutual Assistance in Criminal Matters

The United States also has entered into a treaty with Switzerland which provides for broad assistance in the exchange of information in criminal matters. The Treaty provides assistance for cases where the alleged violations would violate the criminal laws of both countries. It is available to the SEC because the U.S. securities laws provide for criminal penalties. The Treaty applies to both court proceedings and ancillary civil proceedings; the SEC thus may make use of its provisions during investigations into conduct which might constitute a criminal offense under the securities laws.

The SEC's experience with the Treaty has been limited because of the lack of dual criminality between the U.S. securities laws and the Swiss Penal Code. However, in several recent cases the SEC has been successful in obtaining information under the Treaty which otherwise would not have been available. Further, the Swiss Parliament is in the last stages of considering legislation which would make insider trading a criminal offense and, as a result, expand the applicability of the Treaty to SEC requests.

E. Exchange of Correspondence with Ontario Securities  
Commission relating to mutual assistance

On September 24, 1985, the Ontario Securities Commission ("OSC") and the SEC agreed, in an exchange of letters, to assist each other in investigations and oversight of the U.S. and Toronto markets. The letters were exchanged in anticipation of the electronic trading linkage of the American Stock Exchange and the Toronto Stock Exchange. The OSC letter provided formal assurances that it is "extremely unlikely" that the Canadian blocking statute will ever be invoked to block cooperation with a SEC investigation. The SEC and the OSC regularly provide each other with the types of assistance contemplated in the exchange of correspondence.

F. Treaties with the Cayman Island and Canada on Mutual  
Assistance in Criminal Matters

On March 17, 1985, the U.S. and Canada signed a treaty which provides mutual assistance in criminal matters, specifically including securities matters. On July 3, 1986, the U.S. and the Cayman Islands also signed a treaty on mutual assistance which provides assistance in matters relating to insider trading and

securities fraud. 1/ The SEC believes that upon ratification, it will be able to utilize both agreements to obtain evidence from these countries.

G. Other Mutual Assistance Agreements

The United States also has agreements with the Kingdom of the Netherlands, entered into force in August 1983, Turkey, entered into force in June 1979, and Italy, entered into force in November 1985. To date the SEC has not made requests for assistance under these agreements.

II. Multilateral Efforts

A. Discussions at the Organization for Economic Cooperation and Development

The SEC has also been a participant in discussions at the Organization for Economic Development ("OECD") relating to international evidence gathering. In September 1985 the SEC proposed that the OECD Working Group on International Investment Policies of the Committee on International Investment and Multinational Enterprises initiate a survey of all Member countries concerning mutual assistance and cooperation in securities enforcement matters. The first phase of this program, the circulation of a questionnaire, is currently under way.

B. Participation in the International Organization of Securities Commissions ("IOSC")

The IOSC was established over eleven years ago as the Inter-American Association of Securities Commissions and Similar Organizations. In an effort to facilitate discussion among a broader base of securities regulators, the Organization has expanded its membership to include 30 regulatory organizations from all over the world. The SEC is an active participant in the organization since its inception and currently serves as a member of its Executive Committee. At its July 1986 meeting, multinational committees were formed to accelerate international cooperation on enforcement and other matters. The SEC chairs the IOSC working group on the exchange of enforcement information.

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1/ Indeed, the schedule of covered offenses includes a definition of fraud which is akin to 10b-5 under the Exchange Act.

Chairman Shad  
February 6, 1987  
Page 5

C. Accord on Cooperation among IOSC Membership --  
Using the US/Japan Agreement as a Model

In November 1986 the Executive Committee of the International Organization of Securities Commissions adopted a SEC proposal relating to cooperation among securities commissions. That resolution provides that each member commission provide other members with assistance, to the extent permitted by law and on a reciprocal basis, in obtaining information related to market oversight and protection of each nation's markets against fraudulent securities transactions. The resolution also requires each member to designate a contact person(s) who will insure the timely processing of all requests for assistance. The resolution has now been submitted to the membership for consideration.

**Attachment B**

KENNETH R. LEIBLER  
PRESIDENT AND CHIEF OPERATING OFFICER  
AMERICAN STOCK EXCHANGE, INC.

February 17, 1987

INTERNATIONAL SURVEILLANCE INFORMATION  
SHARING ARRANGEMENTS

The development of trans-national capital markets accelerates with each passing day. This trend should be encouraged, moreover, as it promises great benefits for the economies of all nations in the form of truly competitive, low cost financing for governments and private businesses. Among the critical factors hastening the development of these international securities markets are technological advances that provide investors with immediate access to all markets, increased investor sophistication and demand for performance, and a trend toward deregulation and change in many countries.<sup>1/</sup>

The American Stock Exchange actively encourages the development of international securities markets. To this end, the Exchange established the first two-way order flow link between a primary U.S. securities market and a primary foreign market, the Amex-Toronto Stock Exchange link. This link currently permits two-way trading in dually traded equity issues. Quotes for linked stocks are displayed on each floor, and orders are transmitted between exchanges via automated

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<sup>1/</sup> Examples of change in foreign markets affecting internationalization include "Big Bang" in the U.K., and the admission of U.S. firms to membership in the Tokyo Stock Exchange.

routing systems. Ultimately, the link may provide participants with two-way access to all Amex or TSE stocks and options. In addition, the Amex is negotiating a licensing agreement with the European Options Exchange that will permit the EOE to trade the Exchange's XMI option during European market hours. The options traded pursuant to this agreement would be fungible; thus positions opened on one exchange could be closed on the other.

The American Stock Exchange views the internationalization of securities markets as a favorable development and it intends further initiatives in this area. Nevertheless, the Amex also shares the Commission's concern that the emerging international markets should be fair, efficient and accessible to all investors. This meeting, therefore, provides a welcome opportunity to discuss the actions that might be taken to ensure the fairness of the international markets, and most particularly, those steps that might be taken to ensure the timely exchange of essential surveillance information. In this connection, I would like to discuss the Exchange's experiences in obtaining and sharing surveillance data with foreign market places.

Our dealings with foreign markets have shown that they are willing to routinely share most of the information that one needs for successful market surveillance. This "easily available" information includes the following trade details: time, size, quote, price, executing broker, contra-broker,

clearing member identity and account type.<sup>2/</sup> We have found, however, that difficulties in developing information sharing arrangements typically arise over the disclosure of customer identity and customer background information. Generally, the reluctance by foreign markets to agree to the disclosure of customer information is rooted in cultural traditions reinforced by secrecy laws and blocking statutes<sup>3/</sup>. In jurisdictions, however, which share a common legal and cultural background with the U.S. and have history of cooperation between regulators, it is relatively easy to negotiate information sharing arrangements that contemplate the exchange of customer information.

For example, the Amex-TSE Linkage Plan provides that the exchanges will cooperate fully in investigating any trades effected through the link even though Canada has a blocking statute.<sup>4/</sup> The Plan further requires each exchange to use its "best efforts" to obtain relevant information from its members and share this information with the other exchange. Of

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2/ "Account type" data indicates whether a trade was executed for the account of a broker-dealer, the account of a market-maker or a public customer's account.

3/ Secrecy laws typically provide for confidentiality of bank records. They protect private interests and, therefore, may be waived with the express or implied consent of the customer. Blocking statutes, on the other hand, generally prohibit the disclosure of documents in the enacting state pursuant to a request by foreign authorities. Blocking statutes protect the sovereign interests of the enacting state and, therefore, cannot be waived by an individual.

4/ The Foreign Extraterritorial Measures Act.

crucial importance, the Ontario Securities Commission advised the SEC in writing during the approval of the Amex-TSE link that it was extremely unlikely that Canada's blocking statute would be invoked to halt an exchange of information (including an exchange of customer information) pursuant to the Linkage Plan.<sup>5/</sup> At present, the Amex and the TSE routinely assist one another's investigations by obtaining relevant information from their members and forwarding it to the requesting exchange. In addition, the Amex and TSE surveillance departments routinely advise one another of transactions effected through the link.

In jurisdictions that do not have a common cultural or legal heritage, however, there is concern that confidential customer information will be used by governmental bodies for other than surveillance purposes if routinely exchanged between market places or regulators. Hence, there is a good faith reluctance to enter into information sharing agreements that contemplate the disclosure of customer information. The difficulties in developing information sharing arrangements with such jurisdictions are compounded by the fact that certain activities which are considered illegal in the U.S., might be tolerated in the foreign jurisdiction. A clear example of this is insider trading.

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<sup>5/</sup> Letter dated September 24, 1985, from Ermanno Pascutto, Director, Ontario Securities Commission to Richard Ketchum, Director, Division of Market Regulation, and Gary Lynch, Director, Division of Enforcement, U.S. Securities and Exchange Commission.

In negotiating with the EOE, the Exchange encountered some difficulties in securing an information sharing arrangement that contemplates the exchange of customer data. As might be expected, these difficulties arose from the presence of EOE rules and Dutch laws that protect the privacy of customer financial information. Two important points, however, must be made about this situation which have applicability beyond the scope of the XMI licensing arrangement.

First, the EOE was willing from the outset to share basic trading information such as time, size, quote, executing broker, clearing firm and account type. This information, moreover, is the key ingredient to conducting an appropriate surveillance program.

Second, the Amex believes that arrangements can be worked out on a case by case basis with foreign markets to ensure the release of customer information. For example, on February 11, 1987, the Governing Council of the EOE approved changes to the EOE's rules which will obligate its members to provide the EOE with information regarding XMI transactions, and authorize the sharing of this information with the Amex. Further, the EOE's options disclosure statement and customer account agreement will be amended to permit the disclosure of otherwise confidential customer information to the EOE and other regulators responsible for reviewing trading in XMI options.

As can be seen, there is no single solution to the problems that arise in developing information sharing arrangements. Each agreement must be tailored to the unique characteristics of the particular jurisdictions involved. The paramount objective, of course, is protecting U.S. investors and preserving the integrity of our markets. However, an over exacting application of every U.S. regulatory standard to arrangements with foreign markets may be counter-productive. For example, such action may offend other nations who might view it as an insult to their sovereignty. Thus regulatory cooperation actually is inhibited. In addition, insistence upon overly stringent information sharing arrangements can frustrate otherwise desirable linkages, thereby placing our markets at a competitive disadvantage to foreign markets. It will not advance U.S. regulatory or economic interests if, for example, foreign markets develop in domestic securities without opportunities for our markets to participate via linkages. U.S. markets and regulators, therefore, must be sensitive to the legal and regulatory environments of other countries in arranging information sharing agreements.

The Exchange believes that there are a number of actions that domestic regulators, market places, and industry professionals might take to develop arrangements for the international sharing of surveillance information. This, in turn, will foster the growth of fair, efficient and accessible international securities markets.

First, U.S. regulators and industry professionals should meet with foreign authorities to encourage the development of common standards of conduct, such as a common view that insider trading is improper.

Second, the SEC should continue with its noteworthy efforts to negotiate information sharing arrangements with foreign authorities such as the understandings it has concluded with Canada, Switzerland, Japan and the U.K.

Third, the domestic securities markets should continue to establish trading linkage agreements with foreign markets that provide for information sharing sufficient to satisfy fundamental regulatory needs. Finally, U.S. securities markets should encourage foreign markets to participate in the Intermarket Surveillance Group.<sup>6/</sup> In the alternative, an "International ISG" might be established. Either development would greatly facilitate the routine exchange of international market surveillance data.

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<sup>6/</sup> The Intermarket Surveillance Group ("ISG") is an organization of eight domestic securities markets. It provides for the daily exchange of surveillance information regarding intermarket trading and it coordinates the conduct of investigations of possible intermarket trading abuses. In this connection, it should be noted that two future markets participate in ISG matters regarding intermarket trading in stock index products and the underlying securities.

SECURITIES AND EXCHANGE COMMISSION

Internationalization Roundtable

February 17, 1987

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Opening Remarks of James M. Davin<sup>\*/</sup>

Some time ago an economist sent me a copy of "The Stock Exchange as an International Market." It is a fascinating study. Starting with the theory of "the inherent tendencies of markets to develop a closer intercommunication, and finally centralization in single great markets," the author enthusiastically traced the development of international markets.

"In the beginning, prices for the same American security in New York and London varied considerably and were established principally by local conditions," wrote the author, J. Edward Meeker, then an economist for the New York Stock Exchange. Soon, he explained, developments in arbitrage kept the domestic and foreign prices for American "international"

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<sup>\*/</sup> James M. Davin is appearing on behalf of the National Association of Securities Dealers, Inc. He is a member of the Board of Governors of the NASD and the NASD's 1987 Vice-Chairman, Finance and a Managing Director of The First Boston Corporation.

securities much closer together than ever before, and these issues enjoyed a much broader market.

"Few features of Wall Street life so irresistibly appeal to the imagination as this extraordinary business, conducted in the various world markets over the flashing cables with a speed vastly more rapid than the roll of the earth. . . America today enters this future period of international financial pre-eminence with a confidence for the future grounded firmly in the achievements of the present," the author concluded.

The year of this study's publication was 1922. The growth and development in arbitrage refers to information transfer - at first by sailing packet ship, then steam navigation, and ultimately by the trans-Atlantic telegraph cable.

About a hundred years earlier, the House of Rothschild reportedly made a fortune by arranging for the results of the Battle of Waterloo to be sent to its trading rooms by carrier pigeon. Some 50 years later, a German named Reuters founded a great news (and ultimately information) network using the same technology - the carrier pigeon.

Have we been here before? For those of us who will listen, history does indeed teach lessons. International investing is more than a current fad; it has been going on for centuries. Dr. Meeker was right; markets do tend to centralize; there is simply no rule that this phenomenon has to occur in one physical location. And in general, the common wisdom of these visionaries is clear; the future has always blossomed from the technologies of the present.

Change is as much a constant in modern securities markets as it was 50 or 60 years ago, but the key difference is its rate of speed.

Certainly London markets accomplished more in 1986 than could have been imagined possible in a decade not too long ago. And it seems as if the modern media won't let us forget.

What we are seeing is a unique confluence of investors, issuers and securities firms at a unique moment of time - the present - in the development of a true Global Equity Market.

It is now only a matter of time before investors worldwide will be able to purchase or sell thousands of quality equity securities from the industrialized nations literally around the clock. Investors today are searching for promising opportunities in the securities of companies located throughout

the world. This is due in large part to the investment performance in world markets during the period 1975 - 1985 with the Japanese Stock Market up 373 percent, the French 324 percent, Canada 257 percent, Germany 246 percent, U.K. 237 percent and the Standard and Poor's Composite for the U.S. up only 134 percent. Interestingly, the NASDAQ market was up 319 percent during this same period.

The worldwide tendency toward institutionalization of equity investment, coupled with a worldwide hunger for positive performance, has propelled investors into global markets.

Along with a desire for performance, investors have sought global markets for both currency and company diversification. Broader selection should, as the theory goes, produce less risk and better results. How can an investor ignore some of the world's largest food companies, defense contractors, chemical companies, technology or pharmaceutical companies? With less than a truly global perspective, an investor does. For example, as a fiduciary, would you encourage your funds manager to limit the stocks to be included in the automobile weighting of your portfolio to just Ford, General Motors and Chrysler . . . or to just Toyota, Honda and Nissan . . . or to just Jaguar or Volvo . . . or to just BMW and Mercedes? Or would you expect and encourage your funds manager to examine the entire universe before selecting those stocks that genuinely represent the best investment?

Global management is finding willing support among many pension sponsors, who in 1986 controlled some \$1.6 trillion of U.S. pension assets. In many cases, we are finding these funds increasingly controlled by a new kind of chief financial officer in the U.S. - in many cases, one with significant experience in the company's overseas operation and no small degree of sophistication in non-U.S. currencies and investments. For the new kind of CFO and others, this accelerating move into global equities from pure common stock investment into bonds in the 1960s; real estate and sometimes precious metals in the 1970s and now to global markets for the 1980s and likely into the early 1990s.

The Global Equity Market is also under way because many issuer companies are scouring the world for the least expensive capital. Today, when raising debt capital, most issuers automatically compare structures, rates, size and costs in financial centers around the world, and the same process has started in the equity markets. One of my associates, Hans-Joerg Rudloff, the Deputy Chairman of Credit Suisse First Boston, has gone so far as to say: "Today, any company that does not search for capital worldwide is likely guilty of negligence." By reaching into the entire pool of equity capital worldwide, issuers ultimately assure themselves of a better offering price and broader shareholder base.

In view of investor and issuer demand, securities firms are competing for the new international business. Already, U.S. firms have over 250 branches in 30 foreign countries, exclusive of Canada and Mexico, while some 150 foreign firms have established branches in the U.S. Some 15 to 20 global firms already operate their own worldwide communications and distribution networks; their average capitalization is \$2 billion; among them, the four top Japanese firms together in 1985 equaled the total profits of all New York Stock Exchange member firms combined.

Seeing these developments, the equity markets of the world are responding: linkages between national markets are being forged; private vendor organizations are speeding the international flow of market information; and more efficient and less costly methods of clearance and settlement of international trades are being developed.

Although problems remain to be addressed, as evidenced by our attempt today to explore a number of relevant issues, the first steps toward efficient international market linkage are now being taken. A case in point is the NASD's linkage with London's International Stock Exchange introduced almost one year ago.

The New London Bridge, as it has come to be known, commenced operation on April 22, 1986, (even before Big Bang Day) with the first intercontinental market-to-market linkage, between London's SEAQ computer system and the NASDAQ system. This linkage has provided the capability of displaying live market maker quotations on some 300 NASDAQ securities on approximately 8,000 dealer terminals in the U.K. Likewise, quotes on an equal number of listed U.K. issues and London traded international issues are being displayed on 3,000 NASDAQ Level 2/3 terminals in the U.S.

We believe that the NASDAQ-London link is an extremely important step in the evolution of international equity trading. It has been extremely well received and promises to provide the catalyst for the development of true regulatory cooperation. In the future, expansion of the NASDAQ-London link is planned to include transaction information and the automated execution of intercontinental trades. In addition, a number of specific regulatory initiatives have been identified for development by the two markets which I shall address in a moment.

The ironic disappointment that the NASD and London have experienced thus far is the very tentative acceptance this pilot linkage has received from the Commission. Quite frankly, we had expected that the Commission would strongly favor the operation of international intermarket linkages. Thus far, the Commission

has been unwilling to approve the operation of the linkage for a full pilot period of two years, which we believe is the minimum duration for experimental operation of a system such as this to justify the expenditure of manpower, resources and commitment needed to bring the intended scope of the linkage to fruition.

The unfortunate aspect of this situation is that the consideration of the Pilot Program has been, and remains, bogged down in the consideration of a rate matter - namely whether the Pilot Program competitively impacts independent vendors because information on the linked securities is being exchanged between London and the NASD without charge. The concern has been that these vendors will not be able to compete for subscribers if the NASD is receiving and giving this information away for free.

This approach places the proverbial cart before the horse by elevating the protection of vendors above the development of an efficient, linked international market. The inability of two marketplaces to exchange information without charge for use within those markets because of Commission action may be viewed in other parts of the world as an unwarranted intrusion into the internal business aspects of a foreign exchange rather than an exercise of its concern with respect to regulation and investor protection.

The Pilot Program is not an initiative to create a new business opportunity for the NASD or its subsidiaries as an information supplier, rather, it is intended to create new business opportunities for the market makers and dealers generally, which comprise the marketplace for the securities included in the link. These opportunities will be expanded to include additional information, and efficient systems for the routing to, or automatic execution of, an order in the best market. The provision of this execution and delivery system and the development and the increased efficiency and integrity of each marketplace should be the ultimate goal of this Commission. The potential for these new opportunities can only evolve if the Pilot Program is permitted to operate without unnecessary constraints benefitting interests other than the markets responsible for their development.

What is needed from the Commission is its support for programs such as these, together with their continuing participation in the structuring of these linkages to achieve longer term goals for our industry. This does not require the Commission to choose between the interest of the marketplace and the vendor because their two interests remain fully compatible.

The marketplace will benefit in the future from the broadest possible dissemination of information on the international securities eligible for inclusion in the link. The worldwide dissemination of this information will be provided by the independent information vendor and not the NASD. During the course of the Pilot Program the NASD is proposing that the information exchange be limited to the provision of information on securities included in the link by the NASD only on the Level 3 terminals at firms making markets in one or more of the linked securities that have market in both systems. At present, only 50 securities have market makers that would qualify to receive the information on these 300 additional Exchange traded securities through NASDAQ without imposition of a surcharge. Hopefully, the number of securities quoted in both systems will increase from the present group of 50 as participation in the Pilot Program expands. The NASD hopes that the Commission will be able to approve the operation of the Pilot Program on this basis for the full two year period requested in our filing.

If authorized to proceed with the Pilot Program, a number of important developments will be pursued by the NASD. The first order of business will be the modification of the NASDAQ system to receive and process transaction information on the most heavily traded U.K. issues. This transactional information will be disseminated to the same market making firms that receive the London quotation information. More importantly,

however, this transaction information is needed for inclusion in the regulatory database maintained for market surveillance purposes. The NASD intends to include this information together with quotation information in its Equity Audit Trail. We would also anticipate the eventual inclusion of clearing data on transactions in securities in the link directly into the Equity Audit Trail. Efforts will be made in the near future to coordinate this effort with the International Securities Clearing Corporation.

We would propose that information comparable to the Equity Audit Trail information on NASDAQ securities, developed for use by the Market Surveillance Department, also be furnished to London in either a pre-formatted display or by way of a continuous data stream. This will provide them with a complete audit trail of relevant data applicable to quotations and transactions in NASDAQ securities included in the linkage. In the event that additional information may be required by London, the NASD would undertake to make available the full range of its Market Surveillance resources in order to provide the Exchange staff with information they deem relevant to the completion of their investigatory effort.

Discussion of joint regulatory initiatives has been assigned a high priority by both the NASD and Exchange, and is expected to result in a number of specific programs being

undertaken during the course of the Pilot Program. These undertakings will be in addition to the excellent continuing cooperation now experienced between the marketplaces. For example, the regulatory assistance of the NASD was recently offered to the Exchange in connection with the trading of Guinness in the U.S. which was the subject of investigation in the U.K. The Exchange has taken the same approach with respect to the NASD.

Finally, a number of system approaches to the routing and automated execution of transactions will be developed for joint consideration by the NASD and Exchange and for presentation to the Commission. The ultimate goal will be to link all market makers in the linkage and assure the execution of a particular transaction in the market that provides the best execution at any particular point in time. We believe that the developments and initiatives embodied in the Pilot Program will significantly advance the process of internationalization and encourage its approval by the Commission.

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The benefits of internationalization of existing markets are far-reaching and profound. Ultimately as Chairman Shad noted in his comments accompanying the Commission's October 9, 1986 Report to Congress, "As our worldwide economic interests

and dependencies are more closely bound together, all mankind will enjoy greater peace, prosperity and opportunity."

The more immediate practical benefits include greater liquidity for investors worldwide, more competitive access to capital and capital markets by issuers worldwide and the dissemination of securities information from major markets on a worldwide basis.

The pitfalls of the internationalization process that we face that can be avoided are:

- 1) The failure to formalize the exchange of information among marketplaces and regulators in the forum and manner evident today.
- 2) The failure to vigorously encourage the effort and commitment needed to develop a globally linked delivery system to accommodate the rapidly growing global marketplace.
- 3) The premature or piecemeal initiation of rule making in the absence of substantive experience with international trading linkages which could result in such marketmaking activities being driven underground or otherwise placed beyond the purview of established regulatory authorities.
- 4) Finally, a regulatory viewpoint that does not recognize the vast cultural differences existing throughout the world and the ever present diversity between unsophisticated individual and institutional investors.

In sum, we strongly urge the Commission to approve the operation of the Pilot Program between NASDAQ and SEAQ for a full two year period of time. Such a laboratory experiment will

provide the Commission with specific evidence concerning the appropriateness of future rulemakings, the identification of verifiable problem areas to be examined and addressed by such rulemakings, and the exposure of the Commission to practical operating experience in this area. The experience to be gained by the Commission will include order routing mechanisms, automatic execution facilities and the creation of international databases of information for surveillance purposes.

# U.S. Securities and Exchange Commission Roundtable On The Internationalization of Securities Markets

## The Toronto Stock Exchange

*17 February 1987*

*Donald R. Unruh*

*Vice-President*

*International Markets*

1987 is the tenth year of operation of the Toronto Stock Exchange's Computer Assisted Trading System ("CATS"). CATS is a fully automated upstairs market with a public central limit order book for each of the 800 stocks it trades. CATS stocks are not traded on the floor. Unlike the more traditional upstairs markets, CATS guarantees the price and time priority of orders absolutely. It is a visible market with transparent pricing. Like other upstairs markets, the average size of a CATS trade in an active stock appears to be more than double the average size of a floor trade in an active stock. CATS trader productivity has been independently measured at 2.75 times that on the floor. At present, there are no Specialists in either market, but rather market-makers acting as both agents and principals. In summary, CATS offers the advantages of an upstairs market and few, if any, of the disadvantages. This is the background and perspective from which I will table my comments on international market linkage.

The first question that comes to mind is the role of dealer markets in the developing global market structure. It is not a question of upstairs versus floor markets - I have addressed that: upstairs seems to be better - but rather, it is a question of quote driven versus order driven trading systems. Distributed dealer networks versus central limit order books. Principal trading, and capital, versus concentrated agency order flow. In a TSE survey of 15 of the world's biggest trading houses, 73% of the firms said that quote-driven telephone-based markets would prevail for international block trading, representing the bulk of the business. Is this view justified?

To answer the question, we constructed computerized simulation models of the NASDAQ, New York and Toronto markets. The only accurate source of systematic book and order flow data proved to be the TSE CATS system. Using this data, our models showed that, if the London dealer market aimed to match New York's trading spreads, it would need roughly three times New York's trading capital. Our best estimate today is that London has achieved about two and a half times New York's trading capital, with a mean spread in its Alpha stocks that is only 0.2% higher than that on the NYSE. While some of our information is tentative and requires more rigorous treatment, we have gained what we feel are some persuasive insights into dealer markets and linked exchange markets.

Dealer markets operate like a loosely coupled network of stock exchanges with quotation traffic in "interlisted" issues among them. The market-maker receives primary order flow from his own population of customers; and typically executes it at the best price established by the market-makers who are quoting reliably at the time. Public order flow does not interact across "markets". At the risk of greatly oversimplifying things, the same model could be applied to a global network of stock exchanges structured like dealers. A core group of international stocks could be interlisted in all markets. The total size at the best bid/ask prices in each centre would combine to form the quotation montage. The critical element of real-time information is either already available or can be provided through existing communications technology. While this is an appealing alternative, we believe that structural problems, similar to those found in dealer markets, would increase global risk.

Dealer markets are significantly more capital intensive than central limit order book markets at competitive spreads *for the same order flow*. They are, therefore, less capital efficient. However, our models have demonstrated that they rapidly become more capital efficient, and exponentially more profitable, as spreads widen. As a result, they can attract large amounts of trading capital. In a quotation-linked exchange network, the dissemination of quotations will make the markets more competitive, spreads will then narrow, the trading intermediaries will use larger amounts of their own capital - and will be exposed to increasing risks for decreasing returns. In our view, such markets could potentially become unstable. They would be at an aggregate risk equal to the risk of the weakest market.

Exchange trading linkages, such as those between the TSE and the AMEX and Midwest Stock Exchanges, improve upon the model. The quotations used by both markets are, in fact, executable orders. But they are market or marketable orders, not limit orders. Real size cannot be effectively handled, since the quotations are typically set by smaller orders. They do not reflect prices for institutional blocks, which have larger inventory carrying costs, increased market risk, and wider spreads. At this size, only access to the limit order book can provide the size and price range for institutional trading. Since international trading is 80% to 90% institutional, *market order* linkages restrict the amount of business that can be done.

Finally, we have the alternative of book-based market linkage. In its simplest form, this could be based on bilateral agreements stipulating that orders must be routed to the home market of the security traded. The information in the book would be available, but in an anonymous form showing only the volume aggregated at each price interval. This would maximize the capital efficiency of the global market for the stock. It would provide uniform disclosure of market conditions to all trading centres, and permit instant and effective regulatory action on trading. It would concentrate liquidity in the biggest book, thereby speeding up the process of price discovery, providing best prices to all users of the market.

While further work is indicated, our preliminary models suggest that such a trading system with four markets, each interacting equally with the central limit order book, would require two thirds of the capital of a Specialist system - and would have a slightly better overall performance. The technology required to implement this system is currently available. We have already licensed and installed it in the Paris Bourse. In the next few years there will be numerous suppliers of such systems. What is required is the will to use it in this manner, which already exists in some markets.

# **INTERNATIONAL MARKET LINKAGE**

**New York**

**21 October 1986**

*by*

*Donald R. Unruh*

*Vice-President*

*International Markets*

**The Toronto Stock Exchange**

## **Introduction**

When the *International Federation of Stock Exchanges* held its 1986 annual conference in New York in June, hosted by the New York Stock Exchange, I had the opportunity to chair a working session on market linkage. In it the views of stock exchanges from some 22 different countries were represented. We reviewed several kinds of market linkage, together with various solutions to international settlement problems, and some innovative trading systems - each intended to address a piece of the puzzle in the emerging global market. Before talking about alternatives for linking the markets, what I would like to do first is to try to envisage the whole market. Who the players are. What their needs are. And how fast and how far it's moving.

The international market exists only because a demand for it exists. Communications technology has stimulated an increasing demand for international equities. The price of the technology is high - a typical international dealing position today costs \$100,000. In fact, over \$1 billion has been spent on dealing facilities in London alone over the past 2 1/2 years. Evidently someone is willing to pay it in order to satisfy a still greater need. Today, it is the fund managers who feel the need to diversify internationally and are paying for it, largely in commissions and dealing costs. In the U.S., for example, the ERISA rules governing the treatment of pension funds are now interpreted so that fund managers who do not invest in foreign securities might be in breach of their fiduciary duty. However, the costs of international dealing are now thought to be too high, since about 65% of the Top tier investing institutions are either dealing directly for themselves or will be by the end of this year.

Tomorrow, it is the members of our stock exchanges who will pay. They will pay with reduced commissions, tighter dealing spreads, and the bundling of more costly facilities into basic services. This will be the

result of intense competition among financial intermediaries together with direct dealing by up to three quarters of the bigger institutions. They will pay willingly because principal trading in upstairs markets will operate on spreads so thin, on a capital base so big, that even second tier firms will not be able to compete, and will lose order flow to the global houses, unless they have the lowest possible trading cost. For the entire life cycle of an order - including order entry, execution, clearing and settlement.

There are many competing issues - economic, strategic, political, regulatory, technological - to name a few. But before I go on, let me first express a rather simple conclusion: In the final analysis, we are all becoming producers of a financial commodity - trade execution. And in commodity markets, the economic law is that the lowest cost producer wins.

I have just stated my view of the basic problem. Let me now tell you how I arrived at this conclusion, and then how it leads to a model for linking the markets.

## Market Research

In order to get an initial understanding of the international market, we've done two major market research studies. The first is an in-depth survey of 15 global brokers and banks. The second is a survey of 20 Toronto Stock Exchange Member offices in Europe. As a result we've segmented the international market into three tiers. Both for investors and for intermediaries.

In the top tier of investors, there are 2,000 to 3,000 institutions that do two thirds to three quarters of the world's trading and up to 90% of international trading. Their average international transaction size today is \$5 million, or 20 times what it was ten years ago, and still growing. Some European institutions have a minimum order size of \$10 million. 65% of them are now dealing for themselves - a condition called disintermediation. A recent survey by Greenwich Associates forecasts that this will increase to about 60% for all institutions by 1990 and 75% for the Top Tier institutions. Even some large corporations are dealing for themselves as a natural evolution of their treasury function - Mitsubishi, for example, operates a \$1 billion trading fund out of London.

In the next tier, there are at least 15,000 smaller institutions and companies. Finally, there are about 110 million individual investors who, due to the recent rise in global equity markets, are growing at more than 10% per year. Together, they account for over 25% of the world's trading.

Market intermediaries are also segmented into 3 tiers. In the top tier are 15 to 20 global firms that operate world-wide distribution and communications networks. They have an average of \$2 billion in capital each. The biggest of them, at the present time, is Nomura Securities which had a profit \$1.5 billion in its 1985 fiscal year. This was equal to 36% of the pre-tax net income of all Members of the New York Stock Exchange in 1985. In fact the top four Japanese houses equaled the total profits of all NYSE Members last year. The top tier is highly capital intensive - so much so that one firm in our survey thought that Goldman Sachs, with close to \$1 billion in capital, would be undercapitalized in the future markets. Recent events have shown that Goldman Sachs thinks so too.

These firms are in fact markets unto themselves. The big four Japanese houses seem to have this view. They are jointly developing their own automated trading system to manage the entire life cycle of an institutional order in a factory automation type of process. Information about the project is closely held, but I was informed by one of the firms that it will be operational in a year's time. A similar thing is happening in the U.K. The largest investing institutions here told me recently that the top 4 or 5 Japanese firms, those with their own automated dealing systems, will provide them with private quotation terminals for institutional-sized quotes under entry - thereby bypassing the Stock Exchange's SEAQ trading system. What surprises me is not that they are doing it, but the eager acceptance by these institutions of such bypass trading facilities. The institutional customers of the biggest intermediaries are clearly prepared to go upstairs and out of exchange markets.

The second tier of intermediaries consists of 100 to 120 firms, each having \$50 million or more in capital. These firms are still dependent on stock exchanges to lay off the tag ends of their business. Interestingly, the top tier firms in our survey support them since they perform the useful function of aggregating smaller orders to feed into them and of taking the tag ends of their business, in turn.

Finally, there are some 5,000 small intermediaries that are boutiques doing a specialized business, or who are regional in character.

Summarizing the role of the market intermediaries, it is clear that the Top Tier firms, who are doing a third to a half of the trading in the world, will have a major influence on the business that stock exchanges will do in the future. If not as Members, then as competitors. 55% of such firms surveyed by us do not believe that stock exchanges will have a major role in regulating the international equities market. We therefore have to ask, "How important is this market?"

We estimate that international equities trading accounted for \$160 billion in turnover in 1985, counting one side only, or about 7.5% of the world equity turnover. Analyzing the simple probabilities, this means that some 14% of the volume done last year had one foreign counterparty, with the other side in the home market; and less than 1% of the volume had two foreign counterparties and was, therefore, detached from its market of domicile. If existing trends continue, then by 1990 15% of global trading will be international, amounting to about \$530 billion. 28% of all trading by that time will have one foreign counterparty, and just 2% will have two foreign counterparties. This volume of trading has serious implications for clearing and settlement systems which will have to cope with more than \$1 trillion of foreign equities settlement per year, counting both sides as we must.

But that's not all. It gets worse, or better, depending on whether you have to process the trades or are a trader. International equities transactions today are triggered by currency movements. In fact, many dealers hold foreign equities as a surrogate for the currency of the home market. Such transactions often result in 2 to 4 transactions in total - including a parallel currency transaction, additional transactions on the tag ends of the trades in order to balance the dealer's book, and possible further currency trades or hedging transactions against inventory. So the impact on clearing systems will be more like \$2 to \$4 trillion in 1990.

But that's not all. This could still be an underestimate of trading volumes. That's because we've made some conservative assumptions about the behaviour of the Japanese investor, who is now the world's biggest foreign trader, trading foreign equities at the beginning of this year at the rate of \$84 billion per year, although it has moderated recently, and foreign bonds at the rate of nearly \$2 trillion per year. I might add that Canada accounts for 12% of Japanese foreign debt investment and ranks

second in Japanese interest only to the U.S. If a fraction of this debt investment moves into equities, the world's equity markets will have difficulty absorbing it. In making the forecast, I have assumed that Japanese foreign equity turnover rates will be the same as domestic turnover rates. In fact, the evidence suggests that they are now 4 to 7 times higher, probably because of volatility in the Yen. If this is still true in 1990, then you can take my world forecast and double it.

So who's going to handle all this trading? The money for it is now mostly in the over-the-counter bond or money markets. In fact, the world's financial assets are now about \$40 trillion, or about 8 times world equity market capitalization, and their turnover ratios are a lot higher than equities, with \$40 trillion per year in foreign exchange trading alone. It's being traded upstairs by telephone by the same guys who brought you the Eurobond market in 1968 and the Euroyen market in 1984. How are they going to react when their biggest customers tell them to take their money out of bonds and put it into an equities trading account? As our market research shows, they will begin trading international equities the same way they are now trading Eurobonds.

They will probably use the same clearing service - 85% said that Euro-Clear is the most likely candidate. All of them would prefer to see a global network of linked book-based depositories with all settlement done locally by book entry, but only 14% think that this is likely, given current realities. It would be much more cost-effective to use book-based systems, particularly since Euro-Clear clears gross and does not permit the netting of obligations and, is, therefore, highly capital-intensive. In addition, equity trades can be rescinded as late as the day before settlement, thereby leading to excessive settlement fail rates. Euro-Clear's equity fail rates currently average 20%; and in other centres it can be as high as 35% to 40%. As a result, demand for the more effective book-based clearing systems will surely increase.

Of course, to be efficient they must be linked to the trading systems. To be even more efficient, I believe that these should be automated trading systems. But what do the traders say?

79% of the Top Tier houses in our sample think that telephone markets will migrate to some extent to screen trading. They feel that central limit order book trading systems, as opposed to dealer systems, will be widely used, but mainly for small orders. Only 27% felt that the upper end of the market, block trading, would be automated in any form.

In contrast with these views, the markets around the world are going in a different direction. For example, London's, or perhaps I should say the International Stock Exchange's, SEAQ system which, with its 1,000 by 1,000 size guarantee for small orders does not provide the central limit order book that is expected here. It is a dealer market in which the bigger dealers will bypass SEAQ for block trades. This only reinforces the notion that in such markets individual dealers can become the market themselves, using private quotation networks and other technologies that stock exchanges themselves would use. At the other extreme, however, the Tokyo market has deployed its CORES automated central limit order book system, currently handling very large business, trading up to a billion shares in one day.

The Top Tier firms are currently building in-house trading systems in any event, so the question might be academic, since they obviously think their business can be handled this way. Despite conflicting views, I believe that automated trading systems will prevail for all sizes of business. At the Toronto Stock Exchange, we implemented the world's first automated equities market in 1977 when we commenced trading with our CATS system. CATS is now the only place where 800 of our listed issues can trade. On June 23rd of this year, the Paris Bourse also started trading on CATS, with all trading on 18 active stocks, including such issues as Louis Vuitton which also trades in ADR form on NASDAQ, being processed in our data centre in Toronto. Within the next 60 days, the Paris system will be the only place where the Paris brokers can trade some 50 active stocks, accounting for about a quarter of Paris turnover. To position our market, CATS is bigger than Instinet, with about 450 trading terminals plus another 4,000 Member terminals making inquiries on our trading books. By the end of 1987 I expect to see 700 to 800 trading terminals in place. Counting both sides, CATS now does US\$29 billion per year in trading, and by the end of this year or early next year it will be \$52 billion per year.

Our own experience in Canada, and the experience so far in the Paris market, shows very clearly that exposure to the CATS trading system creates a strong base of support. And it is not small business, since the average CATS trade is 50% larger than the average floor trade. The trading volumes in the Paris system are now growing at the rate of 15% per week per stock. Furthermore, academic studies indicate that market quality does not suffer. Finally, I was told recently by our two largest firms that their CATS traders are making several times more money than

their floor traders - a very sound argument for increased use of automated trading systems.

I have now talked about some of our market research findings and have pointed out the very real possibility of international trading being taken upstairs by the global trading houses. Many of us are, I know, painfully aware of the effectiveness of these block traders making markets in the globally traded issues. There is no doubt that they will increasingly do so. If for no other reason than the fact that these firms are implementing proprietary trading technology which is faster, cheaper, and better than what most stock exchanges can offer.

Some people have pointed out that, in any case, their trading will flow back to the market of domicile, as the final lay off of the business, and that there's no real threat. A probability analysis of trading counterparties as shown earlier, seems to support this. There are, however, two points to consider. The first is that the flowback to the market of domicile, in the final analysis, is a function of where the shareholders are - the buyers and sellers of last resort. Today, only about 17% of the shares of the internationally traded equities are foreign owned. If this figure increases to 30% by 1990, then the probability of flowback will decrease exponentially. The second point is that share turnover ratios are much higher in international markets than in the domestic market for the same stock, largely due to currency fluctuations. In fact, today some stocks do more trading offshore than domestically, and are becoming detached from their markets of domicile. When both trading turnover and share ownership are considered in this light, we must conclude that when more than 70% of trading and between 20% and 40% of share ownership are both lost to a foreign market, it is next to impossible to get it back. A real threat does indeed exist.

## **International Market Linkage**

The driving force behind these market trends is deregulation of the markets on a global scale. This has introduced massive dislocations of capital and, more importantly, a level of competition in the financial services sector that would have been unthinkable a few years earlier. Inevitably, some financial centres will have global ambitions, thereby putting pressure on other markets. For example, John Young, head of markets at the London Stock Exchange stated a couple of weeks ago in a private meeting that the objective of the International Stock Exchange, as

London's market is now called, is to take 10% of New York's trading volume during New York market hours, in addition to the trading gained before New York opens. This pressure for change is felt everywhere. Brokers are taking their trading to wherever they can operate free from unnecessary regulation or excessive costs. They are making markets upstairs, engaging in net dealing, committing rapidly increasing amounts of capital to bigger and more highly leveraged principal positions. Because that's what's needed to stay alive under these conditions.

The 1984 SIA delphi study on the future of the securities industry pointed out, with a broad consensus, that the survival factor for the rest of the decade is cost control. I rather like the statement made by Anthony Greayer, Deputy Chief Executive, Hoare Govett at a Euromoney conference held in January of this year: "We're going to hit a completely new game in the future. Either we're going to be acting as principal, and its only the bid/offer spread that we've got to play with in which to encompass all our costs including, critically, the cost of clearing and settlement, or we're acting as an agent and we're going to see our commissions squeezed."

Any cost squeeze on brokers will inevitably flow back to stock exchanges. Stock exchange Members will demand reductions in service fees, including the possible elimination of transaction fees from those exchanges that have them. The trading technology that is now required is expensive. However, when these trading systems are linked, either directly or indirectly through arbitrage, economic rather than technical laws will take over, and the low cost producers will prevail.

Certainly, automation reduces costs relative to what they were before. But we increasingly need to have global comparability of our costs. For example, in Toronto we did an independently audited study of our trading costs in 1984. It showed that on our trading floor our total cost per trade, one side, was 87¢. Today, our cost of doing a CATS trade is about 20¢ per side at current volumes. By comparison, the London Stock Exchange recently announced its SAEF system for automated execution of market orders to be introduced in 1987 with a reported cost of 2 pounds, or roughly \$3.00 per trade per side, not including settlement. Fifteen times the cost of a visible, fully automated trade in CATS. I do not need to point out that investors can go virtually anywhere in order to obtain the lowest cost of trading, or that it is equally easy for low cost automated markets to expand to any other country and, even with the increased communications cost, be competitive.

We no longer have the monopoly that we once did in our own countries. The users of the markets in most countries have a choice now, at least for the most active stocks. Communications technology provides them with the means to take their business virtually anywhere. If we are to survive, we have to adapt to the emerging economics of global trading. To repeat what I said earlier: trading is becoming a commodity; and the economic law in commodity markets is that the lowest cost producer wins, all other things being equal.

Our institutions and corporations are increasingly deciding that securities trading is an integral component of their operations. Investment opportunities, and even the investment regulations in some countries, are forcing them to go abroad. And global communications services vendors are making it cheaper to go across the ocean than across the country. These trends are forcing stock exchanges to align themselves with the needs of their biggest players and to link to other markets in order to keep their customers. The need to link markets has never been more apparent. As Dr. Johnston said, we should all hang together, or we'll all hang separately.

Market linkage was the main subject of the *International Federation of Stock Exchanges* conference in June. In the discussions I chaired, we examined some of the implications of international market linkage, and while there was general agreement that these linkages are an important first step, the best method of linking markets could not be agreed upon at the time, although the majority of support was for the last of the alternatives that I will now describe.

- First. Passing a common order book to markets in different time zones to operate in the prime hours of each market. For example, the system used by IOCC. It was reported that only small limit orders are actually passed to other markets in this system - due to risks caused by volatility in the products traded, both for investors and for the exchanges which have to guarantee the orders sent to it, and the loss of control of positions placed in it overnight. The Montreal Exchange said that it had suffered "huge losses" because the book is not automated and trade-throughs occurred. By this I mean that only an automated book can guarantee that limit orders at a particular price will not be missed when the market moves past them. It was felt that big positions could

not be effectively managed in such a system. A further problem is that, if after-hours trading is permitted, as it is in many European markets, it will be very difficult to pass one's positions in the book to someone else while still trading.

We conclude that automation of the public limit order book is a pre-requisite to passing the book to other markets. Because only a fully automated book can guarantee the price and time priority of an order absolutely. But the corollary is that, if the book is automated, it doesn't need to be passed to other markets. It can be accessed from other time zones using computer terminals, markets can be made just as effectively, trades can be reported where they originate, and such a system is really no different than a central limit order book fixed in its market of domicile. It is only when markets prefer to use a trading floor that this kind of linkage is required.

- Second. Interlisting was considered by the Swiss to be a form of linkage in that it enables a local constituency to be built up for foreign companies. It also permits institutions, such as pension funds, which are prohibited from investing in unlisted securities to invest in them. We noted, however, that an interlisting strategy by itself is inadequate in that, except for the biggest issues, which are interlisted anyway and have a local constituency, the home market of the security will be more liquid. Any big positions traded in the foreign market would probably have to be laid off there. This implies that the foreign securities firms would also need to be Members in the home Stock Exchange of such securities. Therefore, interlisting without inter-Membership is not a effective strategy. For obvious reasons, this is not feasible on a large scale around the world at present, but will become so in the future when more open markets exist.
- Finally, we come to the alternative of providing electronic access to a single limit order book located in home market of the securities in question. This would permit the trading to always be done in the most liquid market. Although it can be argued whether this market will be any more liquid when the major users of it are at home in bed, and the trading is

being done by foreign securities firms with a small number of shareholders in their own time zone.

Analysis of this question leads to a discussion about the value of the book itself. The home market will create the deepest book of limit orders since we know that 83% of the shareholders and 92.5% of trading in internationally traded equities is there. Recent academic work amply demonstrates that the deeper the book is, the more liquid the trading in that market becomes. Therefore, we must conclude that the most liquid markets will occur when the book in the home market is accessible electronically, when, in effect, the liquidity of the home market is exported to other time zones.

Of course, this implies that the market must have an automated book and must operate it outside of its normal trading hours. Only a few Stock Exchanges can do it at the moment, but *within 5 years virtually every major exchange in the world should be in this position.*

In all cases, some form of membership in linked markets is implied, whether it is direct membership, or electronic access membership. This will, I believe, be a significant ongoing question concerning linked markets.

The issue is further complicated by competitive factors. We make the following observations based on our market research:

- The biggest trading houses in the world now do a bigger business than many national stock exchanges. Acting as principal, they can now take on a few of the internationally traded issues and break the natural pricing monopoly of the home market in all but the biggest stock exchanges. They can become *the market* for such issues. Unless we move quickly to consolidate trading in a single central limit order book in the home markets of these issues, they will not only continue as a threat but will increase. Rapidly growing global communications and trading networks will make it possible, no, probable - as recent developments in the dealer market in London demonstrate.

- International trading is stimulated by currency movements more than any other factor. Movements of 1% per day in the major currencies are now the norm. The global securities firms deal in these currencies, in size, every day - Stock Exchanges do not. The magnitude of currency movements may not be clear to everyone here. By way of example, a trade of 10,000 shares of IBM at this volatility level could change the settlement price of the transaction, when expressed in a different currency, by \$12,000 per day between trade date and settlement date - and this does not include the currency conversion spread. Quotation in multiple currencies for trading equities is a pre-requisite for international stock exchange business; and efficient low cost methods of currency translation must be employed. One example is the automated currency conversion system operated by the Toronto Stock Exchange for business done across its inter-professional trading links to the AMEX and the Midwest Stock Exchange. U.S. Specialists can trade and settle Canadian stocks at the quoted Canadian dollar price in U.S. dollars without being aware of an intervening currency transaction. The importance of this feature is highlighted by the fact that, on most days, there are more currency transactions than equity trades across the links, implying that our Members are using the currency facility for their other business. A demand exists.

I believe that the long term solution is a network of markets linked to each other in such a way that only one order book exists for each stock, and is located in the home market of the stock. At the present, this is not practical for all markets due to differences in methods of trading, hours of operation, and the level of automation. However, in my opinion, that is only a question of time.

The Toronto Stock Exchange is attempting to facilitate such linkages through the sale of its CATS system and sophisticated market information systems. We are the only market in the world making our most competitive weapons available to other markets in different time zones. Our goal is to promote co-operation and market linkage rather than competition. Within the next 6 months, we expect to have deals with 3 or 4 stock exchanges in all. Why is this important?

It is important because of the way in which money is invested today. We are witnessing the rise of the global fund manager. Such managers no longer invest simply along geographic boundaries. The new boundaries are currencies, economic stability, and, most important, the ease of entry and exit, and the cost of doing business. Such managers will spend time dealing in any one market in proportion to their investment in it. The deciding factor is usually market capitalization. A 1% market share gets you 16 hours per year of his time, including his worrying over a currency whose volatility might cost more time than it's worth, and for which there are usually no hedging instruments, or over a market whose lack of depth might require months to unwind a single position.

The Top Tier houses are aligned with these fund managers. These firms are developing trading products that permit global investment on a sectoral basis. If a fund wants to invest in golds, for example, it will buy a gold index product based on, say 3 South African, 2 Canadian and 1 Australian gold shares, in the currency of its choice. This will then be executed immediately priced off a composite global market information system, as principal. The firm will then commit this transaction to its in-house trading system to be processed as a basket trade, taking into account its own positions in the currencies and issues in question, together with possible hedging using gold options or futures. No one stock exchange acting alone can do this. The Top Tier firms can beat us all with this strategy.

The solution is, as mentioned earlier, a global network of stock exchanges linked to each other, and with a single automated book for each stock in its country of domicile. As described earlier, this would provide the highest degree of liquidity for trading in those stocks. At the same time, it would reduce the threat from third party trading networks by permitting all instruments across the network of exchanges to be traded as if they were local, with greater efficiency, a higher degree of confidence, better visibility, and lower cost than the competing dealers. It would also permit the development and regulation of trading products configured across markets and across currencies. A parallel network of linked book-based clearing and depository systems is also required, if we are to be completely competitive on a speed and cost basis.

## **An Alternative Market**

Dealer markets, such as London, do not support linkage to stock exchanges which utilize a central limit order book, for the technical and structural reasons I have exp~~ort~~ed today. Accordingly, in the *U.K. only* the Toronto Stock Exchange is adopting a radically different approach. The Board of Governors of the Toronto Stock Exchange has approved a trading plan to be put into operation on or about February 23rd, 1987, subject to obtaining any regulatory approvals that might be necessary. The plan consists of the following elements:

- U.K. investing institutions will be provided with TSE CATS trading terminals. They will have access to our order books and will be permitted to enter orders directly into our trading systems. All such orders will use the clearing number of a TSE Member. They could use a different number on every trade.
- The TSE will open its market at 9 AM London time and close it at 4 PM Toronto time for roughly 12 hours per day of trading.
- TSE and New York and NASDAQ stocks will be traded.
- Quotations will be disseminated in Pounds Sterling, U.S. Dollars, or Canadian Dollars, selected by the user of the trading terminal, at his option; and he will be able to clear and settle any single trade in any of those currencies in a manner which is virtually invisible to him.
- A parallel 5 day forward currency market will be moved into CATS; and anyone who is qualified, domestic or foreign, bank or broker, will be permitted to make a competitive market in these currencies.
- A global market information system with equities data from all Canadian and U.S. markets, the U.K. and Japan will be available on the trading terminals.
- The system will be called CATS-International.

If you have any questions concerning the matters raised in this report, I will be pleased to answer them, if possible, at this time.

"International Challenges: A National Focus"

Introductory Remarks to the  
SEC Roundtable on Internationalization  
February 17, 1987

by

Richard W. Myers

Senior Vice President

International Securities Clearing Corporation



Our topic today can be summarized in two words:

international and national.

First of all, it is the SEC, our national regulator, and the growth of international trading which bring us here today.

More importantly, most of us are focusing on how best to support and encourage international trading in securities markets and in equity and bond issues that are still basically national in many ways.

I think that we would all acknowledge that these national aspects, or at least the lack of coordination among them, represents a serious constraint on the potential of a truly international marketplace for equities and bonds.

International dealers face challenges associated with national currency risks, time-zone disadvantages, limited market capacity, varying settlement calendars, political risks, different and sometimes restrictive regulatory and tax structures, and unfamiliar accounting standards.

Yet the most fundamental challenge is determining how, and in some cases, whether a trade, once it has been executed in another market, will be actually settled, and at what cost. As we all know, the viability of any market depends on the ability to deliver product and transfer funds in a timely and effective manner. The international trading markets are no exception.



We will hear today about the various means by which exchanges and market systems are trying to position themselves within international networks. Most are pursuing strategies that will enable them to remain competitive by providing extended trading hours, more foreign listings, expanded foreign memberships, and the ability to add innovative hybrid and derivative financial instruments that seem to crop up overnight.

With virtually every major national market focused on surviving and profiting in the new "global" order, the closer these markets are linked, the stronger will be their need for efficient, coordinated, cross-border settlement capabilities. As the volume of trading across national borders expands, so does the risk of trading profits becoming administrative losses. The creation of a viable, international clearance and settlement system to minimize transaction costs and to accommodate high-volume trading seems to be a prerequisite to realizing the global market's potential.

Centralized clearance and settlement has proven effective in many national markets and in the Eurobond market. Yet, for international trades, the idea of constructing a single global registry for equities, which every market participant would join, represents only one theoretical solution, and in a political context, it is probably the most difficult and sophisticated.

Just as a single world currency has so far eluded the foreign exchange market, it seems that a single global clearing



approach is not a realistic short-term expectation for the world's securities markets.

Yet, many of us would favor global clearing standards, cooperatively defined, as our ultimate goal. In order to encourage that trend while serving near-term needs, the major clearing systems and depositories associated with the largest capital markets and most widely traded securities issues are slowly beginning the odyssey. We recognize that in order for our participants to be most competitive internationally, they need to be able to operate within, and not outside, the trading and clearance infrastructure of national markets.

So, market to market, one-way or reciprocally, we are beginning to structure bridges which allow our firms to pursue business opportunities in other markets and which also enable our markets to make foreign equity and bond issues available for trading locally.

At ISCC, we are the internationally-oriented component of the largest SEC-registered clearing corporation. As such, we have a stated mission which is built around supporting the international needs of US-based participants.

To date, our primary means of doing so has involved linking major clearing and depository systems with our participants. So far, we have an incoming link with The Canadian Depository for Securities Limited (CDS), and an outgoing link with the London Stock Exchange (LSE), with an incoming link from the LSE to ISCC



shortly. We are also in the process of establishing links with Cedel and Euro-clear, and through them, to national clearing and depository systems in continental Europe. Additionally, we are working with the Tokyo Stock Exchange and its clearing organization, Japan Securities Clearing Corporation (JSCC), for development of a clearing link with that very important market.

Each of these clearing links is intended to encompass central recording of trade data, an industry-accepted trade accounting method, controlled exchange of securities and funds, local custody, third-party deliveries and transfers. Each is initially based on accessing the traditional infrastructure, and tailoring it to international needs.

For example, ISCC's outbound link to the London Stock Exchange enables an ISCC participant to settle UK securities traded over-the-counter with a London Stock Exchange member firm or with another ISCC member. The ISCC participant in the US reports the trade details to ISCC using the automated format of the LSE's "bargain record" to input price, counterparty, settlement date and so on...the usual details any clearing system needs to know in order to process a trade. Transfer instructions are also input for each trade. ISCC batches together this trade data from all participants and sends it to the LSE's Checking System.

The Checking System is a comparison system. It attempts to match the purchase and sale bargain records submitted by LSE firms and by ISCC, on behalf of its participants. For each



user, including the ISCC participants, the LSE Checking System issues daily reports showing which of its trades have matched and which have not. If a trade match does not occur at first, ISCC participants can correct or cancel their input by following the same procedures as LSE members use. However, with ISCC acting as both input/concentrator and output/distributor, ISCC participants can always submit their input and receive their output locally in the US.

Matched trades are next routed to the LSE's TALISMAN settlement accounting system. Preparations begin for the eventual settlement of securities and funds, generally on the fortnightly Account Day. Daily reports from TALISMAN document the status of completed and pending settlement activity.

Several days before Account Day, in order to receive settlement funds promptly, selling firms must deposit the securities they have sold for delivery within TALISMAN. ISCC participants' shares are usually held overseas, so they generally arrange to have their UK custodians make the deposits.

Then, TALISMAN continues in its usual processing, temporarily transferring those deposited securities into its book-entry nominee, SEPON.

On Account Day, TALISMAN allocates the SEPON securities to buying firms, on a trade-for-trade basis. Then, TALISMAN automatically notifies the registrar to transfer the shares from the SEPON nominee into the purchasers' names.



While their newly purchased shares are being re-registered, ISCC participants, like LSE members, can expedite delivery-versus-payment to institutional customers by temporarily using TALISMAN Stock Notes.

Eventually, most ISCC participants' UK securities are immobilized in a London custody account or redelivered on to a third-party institutional client. In all cases, though, our goal is to keep the securities certificates in a controlled environment within the City of London.

Money settlement also occurs in London each day, in tandem with the securities movements. Each morning, ISCC pays or receives two net figures, one in British pounds sterling and one in US dollars, representing the total value of all participants' settlements. In turn, ISCC's bank in London debits or credits participants' sterling and dollar bank accounts.

The key benefit of our ISCC-LSE link is the efficient, local access gained by domestic US participants -- non-members of the LSE -- into the LSE's settlement system. By adapting to LSE's formats, ISCC participants can clear trades on a par with LSE members -- as dealers, not customers. We currently have four participants piloting this link, and four other firms are in queue.

On the other side, ISCC's inbound link with the LSE will enable the LSE members to settle trades in US issues through National Securities Clearing Corporation (NSCC) and The Depository Trust Company (DTC).



ISCC will sponsor the LSE into NSCC and DTC. To ensure that ISCC will be able to meet its obligations to NSCC and DTC, the LSE will assume the same responsibilities which ISCC assumes through the sponsorship arrangement.

Thus, the LSE will meet whatever clearing fund obligations ISCC will have in NSCC and DTC and will have the same assessment liabilities that ISCC will have to each clearing agency.

Beyond initial market-to-market links, however, ISCC believes that internationally-harmonious clearing capabilities must be developed on a global scale in order for international trading markets to continue to expand successfully.

We believe that the most productive way to navigate the channels between world's financial centers is by collaboration between industry clearing organizations representing their national constituencies' international commitment.

It was this challenge -- to represent our national participants internationally -- which prompted the creation of ISCC 15 months ago and has guided our progress to date. It will be our central topic this morning.



**ROUNDTABLE ON INTERNALIZATION**  
**February 17, 1987**

**Remarks of**

**Edward F. Greene**  
**Cleary, Gottlieb, Steen & Hamilton**  
**Washington, D.C.**

The growth of alternative markets means choice as to the market in which to finance. At the same time, given institutional interest in diversifying investments by types of issuer, currency and country, we can expect to see growing cross border securities activity. Thus, securities distributed in one market may well trade in several markets. The rapid growth of the technology of telecommunications, the movement to book entry systems and the lack of restrictions on currency transfers makes it easy for U.S. institutions to purchase securities in all markets around the world. Moreover, whereas the international marketplace for new issues until recent years related to debt largely, international offerings of common stock now are quite common. In response to these developments, there has been an increase in U.S. institutions' and pension funds appointing non-U.S. investment advisers with discretion to invest in foreign securities.

Accompanying these trends has been a growing uncertainty among members of the securities bar as to reach of the registration provisions of the U.S. securities laws, especially with respect to:

- (i) Foreign and international securities distributions which are not registered in the U.S. and
- (ii) Subsequent sales into the U.S. of these securities distributed abroad.

The last time the Commission spoke in any comprehensive way was in 1964, when it issued Release 4708. That release was issued because the interest equalization tax then in effect had led to U.S. issuers selling to foreigners off shore. Questions had arisen whether use of jurisdictional means inevitably implicated the registration provisions of the 1933 Act. The questions were legitimate because the courts have interpreted the jurisdictional nexus of the acts broadly

to confer jurisdiction, especially in fraud cases, and the Commission itself had been equally expansive. The release was important, for it established the general principle that no registration would be necessary despite some use of jurisdictional means if the steps taken in the offering "are reasonably designed to make the distribution come to rest abroad." That judgment was premised on a judgment that the "registration requirements" were primarily intended to protect U.S. investors.

At time of release, the IET applied to U.S. purchasers of securities issued by non-U.S. issuers. The tax in and of itself represented a significant economic disincentive to U.S. buyers. With its effective repeal in 1974, securities lawyers' developed elaborate procedures designed to substitute for the disincentives of the tax. These procedures were developed in connection with debt offerings, and many were approved in

no-action letters. Their substance can be summarized generally as follows:

1. Invitation telexes to prospective underwriters and dealers state that the securities will not be registered and cannot be sold in U.S. or to U.S. persons.
2. Participants in distribution agree contractually not to sell to U.S. persons or residents, wherever located; foreign branches of U.S. banks, however, are allowed to buy under special procedures. [With respect to securities of the same class acquired otherwise than in connection with the distribution, agree not to sell in U.S. or to U.S. persons prior to 90 days after completion of distribution as determined by lead manager. Sales of distribution securities are accompanied by confirmations.]

3. Securities are not available in definitive form until 90 days after the lead manager declares that the distribution is complete; that is the securities are "locked up." Underwriters agree upon request to confirm to the lead that they have sold all allotted securities.
4. During the lock-up period, dealers are required to include in their confirmation notice that the securities cannot be sold to U.S. persons or residents.
5. When the lock-up expires, the beneficial holders must certify that they are not U.S. persons or residents to obtain definitive securities.
6. The offering circular describes the restrictions.
7. Press releases and tombstone advertisements state that the securities have not been registered under the 1933 Act and that they may not be sold

in the U.S. or to U.S. persons as part of the distribution. Tombstones usually not published until the closing date, or such later time as the lead managing underwriter believes the distribution to have been completed.

8. After the lock-up, the securities are generally thought to be seasoned.

Two observations about these restrictions. First, they are not territorial -- no U.S. person or resident can participate even if the offering and sale is entirely abroad. Secondly, they are of limited relevance to equity offerings, because such offerings cannot be "locked-up."

These procedures reflect the way the Commission and the staff often makes law in new areas. First, a general release is issued; then the release is explicated in a series of no-action letters, which I would refer to as "tea-leaves." The bar then reads those tea-leaves and at times asks that more

be added to the brew to keep it strong. The result is that a lore grows up that has a life of its own. Moreover the lore spreads; indeed, we have at times seen these procedures built into dollar issues by non-U.S. issuers where there is no market at all in the U.S. for their securities and where the distribution occurs in their home market. The fear of the 1933 Act is pervasive.

This is not to denigrate the no-action letter process. It is an innovative and resilient response to the need to fill in the intertices of any statutory system. At the same time, however, one must occasionally step back and take an overview, and remember that often the procedures volunteered may go beyond what the law requires in order to obtain the letters. Indeed, in my judgment, that is what happened here and accounts for the evolution of restrictions that are not territorial.

While there are many short-comings conceptually in these procedures, I will limit my remarks to the types of offerings that should, as contemplated by Release 4708, be exempt from the 1933 Act.

- The 1933 Act requirements should apply to offers and sales in the United States and should not apply to offers and sales outside the United States, by any issuer, U.S. or non-U.S., to non-residents of the United States. U.S. citizens resident abroad should look to the protection of local law. At the same time, foreign citizens resident in the U.S. are entitled to the protection of the Securities Act.
- Corporations headquartered and primarily operating in a jurisdiction (wherever incorporated) should be treated as

residents of that jurisdiction. Foreign corporations should be treated as non-residents of the United States, even if in connection with securities transactions with such corporations there are contacts with U.S.-based officers of an affiliated corporation, unless the foreign corporation has no business purpose other than to invest in unregistered securities.

- Insurance company and bank branches operating in a jurisdiction and subject to regulation by that jurisdiction should be treated as residents of that jurisdiction (an approach reflected in the Commission's recent release on Section 3(a)(2)).

- Transactions with foreign-based investment advisers or fiduciaries should also be treated as non-resident transactions if the advisers are acting with discretion.
- But the territorial principle should not be applied inflexibly; there should be permitted variations; for example, although located in the U.S., the following entities should not be entitled to benefits of the 1933 Act.
  - i) International entities such as the UN, IMF, World Bank and their pension funds.
  - ii) International banking facilities of U.S. banks.
- At the same time, specific targeted groups of non-resident Americans, such as armed

forces personnel stationed abroad should be entitled to the benefits of the 1933 Act.

- This approach does not mean one should be insensitive to flow-back. If a principal market exists in the United States with respect to securities of an issuer, restrictions should be incorporated into an offering to give assurance that the distribution will come to rest abroad and is not targeted for the U.S. market. These restrictions need not be as elaborate as the staff and the bar have devised, but there should be some. In a submission to the staff, we have suggested what those might be. Moreover, with respect to restrictions, distinctions

should probably be made between debt and equity securities *and between Canadian and other non-U.S. issuers.*

- However, one must recognize that with many issuers, there will be cross border trading, initiated often by U.S. investors. Some of that trading will be flowback after an offering and some of it will occur whether or not there has been a primary distribution. Flowback into the U.S. of a foreign issuers securities should not result in imposing Exchange Act reporting requirements unless that Issuer voluntarily offers such securities in the United States or lists such securities on an exchange. If secondary market transactions result in imposition of our reporting requirements, foreign issuers

will take steps to preclude U.S. ownership, <sup>which would jeopardize U.S. investors.</sup> Investors were willing to make initial investments based upon available information; while the 1933 Act assumes U.S. investors cannot fend for themselves and waive compliance with the Act, such a notion imposed upon foreign issuers whose stock is traded without their consent into the U.S. would be offensive to them and a violation of their notions of comity.

• Finally, the briefing materials ask "If sales could be made without restriction to U.S. residents abroad, would primary offerings be likely to be driven offshore?" No, with respect to U.S. issuers, U.S. issuers are sufficiently inured to the Act that they will finance

in the best market. The presence or absence of registration is not a factor. Foreign issuers, however, would probably prefer a Euromarket, especially a Euro-equity market if U.S. institutions could participate. The answer, if that is the case, might be to ease restrictions solely with respect to U.S. institutional investors who have affiliates abroad. Because of the cost of execution, U.S. institutions are in any event the primary purchasers.

I would be glad to answer any questions.

February 17, 1987

SEC Roundtable on Internationalization  
of Securities Markets

STATEMENT OF PETER C. CLAPMAN  
Senior Vice President & Associate General Counsel  
Teachers Insurance & Annuity Association--  
College Retirement Equities Fund

I appreciate this opportunity to discuss some of the concerns of CREF about how uncertainty and erroneous misperceptions about U. S. securities laws and the SEC can adversely affect American institutions investing abroad. International investing has proved to be very successful. The record is good even with the investment process being more difficult in some ways. Some problems are inevitable, different time zones, different economic environments. Some problems, however, costing Americans millions of dollars are not inevitable but result from uncertainty and misunderstanding abroad about our laws and regulations. These needlessly prejudice American investors.

Such concerns should be addressed here at this roundtable. I believe we can offer reasonable suggestions as to how the SEC can clarify its position without compromising its regulatory responsibility. The purpose of securities regulation is investor protection. In the overseas market,

currently, misunderstanding is causing not protection of Americans, but prejudice to Americans.

I will discuss these issues from the experience of CREF, a major American institutional investor that has been investing on a global basis since 1973. CREF, along with its companion organization TIAA, provides retirement benefits for the employees--over 800,000 individuals--of over 3,800 colleges and other educational organizations. CREF is all in equities with assets of approximately \$28B, \$3B being overseas.

How did CREF get a head start in international investing. In 1973, CREF was investing in ADR's of Japanese companies. Those Japanese companies typically issued rights to shareholders--rights that gave the owner the right to buy new shares of the company at an attractive price. ADR holders, however, did not participate in rights offerings--such rights were sold for cash. If the market in such rights were efficient, their cash price should just about match their exercise value.

After a while, we realized that time after time the price we received on the ADR was not the true value of the rights. All other investors exercised the rights and we found they knew what they were doing. This was an inefficient market--and we decided that CREF would not realize the fullest

benefits unless we directly invested in the stock of these foreign companies and could exercise these rights. CREF began direct investing in 1973 in Japan, and expanded to a global investment program in 1978, aiming for about a 10% asset diversification. We have achieved this goal.

CREF has been an active and involved investor in the overseas markets, refusing to take a "no" answer as to last word. For example, when we first started investing, Sweden allowed a very small limit in the amount a foreigner could invest in Sweden. We petitioned the Ministry of Finance and, based on our record of investing for the long term, persuaded that government to give us a much higher limit, enough so that we were able to have an appropriate investment program in Sweden. Likewise in Belgium there is a high withholding tax on dividends. CREF was able to petition the government to issue a Royal Decree exempting educational organizations such as CREF from the tax.

Now, after investing directly for 14 years, we continue to observe that the market inefficiency in the pricing of rights and related offerings we saw in 1973 persists today. This is true not only in Japan, but in all markets. Thus, if an investor cannot exercise rights or otherwise does not have the normal investment prerogatives that all other investors in the country have--we are adversely affected.

Now, where is SEC clarification needed? We have a significant portfolio of British companies. In recent years, in some cases we were precluded from exercising rights offered all shareholders except Americans, based on the erroneous impression that under U. S. law Americans must be excluded. We lost the bargain the rights would have given us--the cash was inadequate for a number of reasons, including high transaction costs and stamp tax. How ironic! We began direct investing abroad to gain the ability to exercise rights. Now, more than 10 years later, we were running into new problems on the same issue.

Why were we excluded? The rights when exercised gave the shareholder newly issued shares. In the U. S., of course, publicly issued new shares must be registered. Some law firms took the position that Americans, therefore, had to be excluded unless the issuers registered in the United States, which they were not prepared to do. It was cheaper and easier simply to exclude Americans. These new shares were identical in all respects to the shares in the British corporation we already owned and accepted the investment risk on.

It can get worse. In some situations the rights to existing shareholders were issued as preemptive rights. Unless the shareholder exercised the rights, such rights simply lapsed. We could not even get cash for the rights we lost.

Now this erroneous perception is even being extended to stock dividends. Companies that for years gave us the opportunity to acquire stock free of high commission costs and stamp duty, deny that opportunity to Americans.

So this is the Catch-22 predicament. Americans can buy stock of a British company in the London markets. They can later buy stock of the same company issued in connection with a rights offering or stock dividends, but only in the aftermarket. In other words, we can buy but not at the bargain price. We think this result is not mandated by the U. S. securities laws. We would like to the SEC to say so.

Let us look at what can happen in a tender offer situation. CREF may own the stock of both Company A and Company B. A makes a tender offer for B's shares which gives all investors the choice of Company A stock or cash. In one case the view was that CREF (and other Americans) could only accept the cash. It is hard to rationalize this result, recalling that CREF already owned A's shares; again a distinction is drawn between A's newly issued shares and its aftermarket shares, a distinction which makes no sense in the marketplace.

In trying to resolve these problems, one situation at a time, I have spoken to many lawyers and investment bankers. We proposed that transactions with CREF were entirely

appropriate as a private placement to an American qualified institutional investor. In some cases, particularly on continental Europe, this view was accepted. It worked in England as well some of the time--we would provide a letter representing to these issuers that we were acquiring the shares for investment purposes--we would keep the securities in custody in the country where the securities were issued, which we always do anyway--and we would sell in an ordinary brokerage transaction in that country. Certainly, however, SEC clarification would have helped, particularly since we did not always have sufficient time to work out the necessary details. For what should be a simple transaction, CREF had to stir up the whole City of London.

We believe this same long-standing recognized American practice of private placements should extend to allow American institutional investors to acquire foreign shares in any new issue as long as the investor does not engage in any resale efforts in the United States. There is, of course, no rational reason for the American investor to sell otherwise than in the foreign markets. Furthermore, if an American investor does not conduct itself properly in this regard, the U. S. securities laws are entirely adequate to sanction and penalize such an American investor who is well within the reach of the SEC. However, we assert that the U. S. securities laws should not be used to preclude Americans from attractive investment opportunities--which this uncertainty more often now causes.

There is a further irony, given the mechanics of how an investor exercises rights or otherwise makes certain types of investments. The managing underwriters receive instructions from custodial banks. The custodial bank must check a box on a form that states that the shares are not held for an American. Obviously, CREF's custodial bank cannot check this box. Yet, an English investment advisory organization that holds shares for the beneficial interest of an American would be allowed to take down these new shares because, as far as the custodial bank is concerned, their records show that a non-American is applying. Thus, this misperception of U. S. law would encourage Americans to have their money managed by non-Americans.

The focus of the new issue problem now turns to France and the new privatization issues. These are issues of stock of companies presently owned by the French government being sold mostly to the French public, with a small amount of stock available to non-French citizens. Such stock has been and is likely to be attractively priced. It is difficult to obtain such stock. An American must take initiative to find out about it--who the underwriters are. Because CREF has been in the French market since 1978, we should normally be able to acquire some shares. A limited amount is available to foreigners--but until now--not to Americans. Why? The French government and French issuers were concerned about doing a private placement with American institutions because of perceived fear of the SEC. Americans were, of course, free to

buy in the aftermarket--after the benefits of the bargain were enjoyed by all others. Hopefully, the SEC will address this issue shortly. Until then, Americans will continue to have difficulty.

A few common themes from these examples can be seen.

First, international investing in securities traded on foreign exchanges is an institutional, not individual investor, market. The SEC should take this reality into account and deal with the issues as they relate to institutional investors, e.g., recognize the long-standing practice in America of private placements, and extend those principles to international investments.

Second, the ability of Americans to participate in rights and other new share offerings is critical. If Americans are precluded, they unnecessarily lose the bargain available by other investors. The amounts of our losses are not trivial. We believe they can be quantified at over \$10 million, and there may be an even larger amount of opportunity losses.

Next, the clarification of the ability of American institutional investors to acquire new issues in general with the right safeguards would not compromise the SEC's regulatory concerns. If there are newly issued shares of a major British

company, for example, American investors almost surely will invest in the aftermarket--after the market has given the initial premium to all investors other than Americans. Thus, the shares themselves are not kept out of the hands of Americans, only the shares when they are most attractively priced. The SEC can address this problem by removing the artificial distinction between investing in newly issued shares and the aftermarket--a distinction that here makes no sense.

Looking at the regulatory concern--we believe that the clarification of these issues relating to institutional investors would not risk the victimization of smaller investors in the United States. American institutions engaging in such investment activities normally would keep custody of their securities in the logical country where the shares were issued. Americans normally would--and if necessary, could be required to engage in any sales only outside of the U. S. Again, the purpose of the law is to protect. Uncertainty is causing the law to prejudice.

Finally, why is the role of the SEC so critical. Over the years, while dealing with many foreign institutions sincerely trying to sort out this problem, I must recognize they may be in an understandable dilemma. They may trust the bona fides of what I am saying, probably they instinctively agree with it. However, such foreigners are faced with the

fact that some lawyers are very cautious and that creates a doubt. Many Americans have difficulty understanding the U. S. securities laws. Therefore, a foreigner, in trying to assess jeopardy under these laws, may simply choose to prejudice Americans rather than run any risk at all. This is where the role of the SEC can be critical. The best solution would be for the SEC to remove the unnecessary impediments for an American institution that chooses to invest abroad. We necessarily take on the risks of such investment--but we should also have the full range of opportunities such investments may bring. Certainly, Americans should have no less opportunity than investors of other countries.

In conclusion, I would again commend the SEC for beginning the process to better develop the appropriate standards for how and when the U. S. securities laws should intervene when American institutions invest abroad.